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An ergodic stochastic control model and a discretionary stopping problem

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AN ERGODIC STOCHASTIC CONTROL
MODEL AND A DISCRETIONARY STOPPING
PROBLEM

by

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Abstract

In this thesis, we formulate and solve one ergodic stochastic control problem and one optimal stopping problem. The stochastic control problem is motivated by applications in the optimal timing of investment decisions. The discretionary stopping problem has the general structure of a perpetual American option and is motivated by a range of applications in finance and economics.

Our stochastic control problem is concerned with an investment project within a random economic environment. This project can be operated in two distinct modes, say “active” and “passive”. The sequence of times at which the project’s operating mode is switched from “active” to “passive” and vice versa presents a sequence of decisions made by the project’s management. In each of its two operating modes, the project yields payoff at a rate that depends on an underlying economic indicator, that we model by a general one-dimensional Itô diffusion. Also, the transition of the project from one mode to the other one can be realised immediately at certain fixed costs. The objective of the problem is to maximise a long-term average payoff that the project’s operation yields, in a pathwise as well as in an expected sense, over all admissible switching strategies. Our results include a complete characterisation of the optimal strategy, as well as explicit expressions for the maximal value of the associated performance index.

We then consider the problem of discretionary stopping a general one-dimensional

Itô diffusion. In particular, we solve the problem that aims at maximising the expected discounted payoff that stopping the underlying diffusion yields over all stopping times. The associated payoff function can take a finite number of values and has a “staircase” form. We derive results of an explicit analytical nature and we characterise completely the optimal stopping time. It turns out that the problem’s value function is not C^1 , which is an interesting feature that is due to the fact that the payoff function is discontinuous.

*Avec tout mon amour, à mes Parents,
à ma Soeur et à ma Tati*

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Introduction

This thesis is concerned with an ergodic stochastic control problem and a discretionary stopping problem. In each of these problems, the objective is to maximise an appropriate performance criterion over a set of admissible decision strategies. The problems have been motivated by applications in economics and finance.

In Chapter 1, we consider an investment project in a random economic environment that is operated in two modes, say “active” and “passive”. When it is in its “active” mode, the project yields payoff at a rate that depends on the value of an underlying random economic indicator, such as a given commodity’s price or demand. We model such an indicator by a general one-dimensional ergodic Itô diffusion

$$dX_t = b(X_t) dt + \sigma(X_t) dW_t, \quad X_0 = x \in \mathbb{R},$$

where W is a standard one-dimensional Brownian motion and $b, \sigma : \mathbb{R} \rightarrow \mathbb{R}$ are given deterministic functions. When the project is in its “passive” mode, it incurs losses that reflect, for example, maintenance costs. The transition of the project from one mode to the other one can be realised immediately at certain fixed costs. The sequence of times at which the project’s mode is changed constitutes a decision strategy that is determined by the project’s management. The objective of the resulting optimisation problem is to maximise the *pathwise* performance criterion

$$\limsup_{T \rightarrow \infty} \frac{1}{T} \left[\int_0^T [Z_t h_1(X_t) + (1 - Z_t) h_0(X_t)] dt - \sum_{t \in [0, T[} [K_1 \mathbf{1}_{\{\Delta Z_t = 1\}} + K_0 \mathbf{1}_{\{\Delta Z_t = -1\}}] \right],$$

as well as the *expected* performance criterion

$$\limsup_{T \rightarrow \infty} \frac{1}{T} \mathbb{E}_x \left[\int_0^T [Z_t h_1(X_t) + (1 - Z_t) h_0(X_t)] dt - \sum_{t \in [0, T[} [K_1 \mathbf{1}_{\{\Delta Z_t = 1\}} + K_0 \mathbf{1}_{\{\Delta Z_t = -1\}}] \right],$$

that quantify the payoff flow associated with each switching strategy over the set of all admissible such strategies. The material of this chapter will appear in Bronstein and Zervos [BZ06].

The type of real option model that we study in this chapter has emerged in the economics literature (see, e.g., Brennan and Schwartz [BS85], Dixit [D89] and Dixit and Pindyck [DP94]). Similar models have been analysed in the mathematics literature by Brekke and Øksendal [BØ91, BØ94], Duckworth and Zervos [DZ01], Lumley and Zervos [LZ01], and Wang [W05]. To the best of our knowledge, all of the real option theory, including the references mentioned above, addresses optimisation problems involving *expected discounted* performance indices. Such performance criteria are justified by standard economics theory because they quantify the present value of the payoff flow that is expected from each admissible managerial decision policy. If payoffs resulting from decision making are of a “monetary” nature, then such an approach is the appropriate one. However, if decision making payoffs are of a “utility” nature, then the use of an expected discounted performance criterion is not ideal because, by their very nature, such indices attach higher values to payoffs arising in the shorter term time horizon. Indeed, the choice of the discounting rate that an investor uses in, e.g., Merton’s classical utility maximisation problem with an infinite horizon can be interpreted as a quantification of the investor’s impatience to consume. Plainly, apart from being associated with “unfairness” when one considers the utility derived from consumption by successive generations, the choice of a discounting rate seems rather arbitrary. As a matter of fact, its main purpose is to guarantee the convergence of the associated performance criteria and the finiteness of the associated value functions. With regard to these economic considerations, one novelty of this problem arises from

the fact that we consider an *ergodic*, or *long-term average*, performance criterion that we maximise in a *pathwise* as well as in an *expected* sense. Such a type of an index is probably better suited to “utility” based decision making in the context of sustainable development because it assigns the same weighting to payoffs enjoyed by present and future generations.

The vast majority of the models in the real option theory that admit solutions of an explicit analytical form assume that the underlying economic indicator is modelled by a geometric Brownian motion. One major advantage of the ergodic criterion that we consider here arises from the fact that it allows for results of an equally explicit nature when the underlying economic indicator dynamics are modelled by a wide range of one-dimensional Itô diffusions. These include the exponential of an Ornstein-Uhlenbeck process, which appears in the Black-Karasinski interest rate model, and the family of constant elasticity of variance processes, such as the square root process appearing in the Cox-Ingersoll-Ross interest rate model. It is well documented in the economics literature that such mean-reverting diffusions present much more realistic models for a range of economic indicators, such as commodity prices, than the geometric Brownian motion. Therefore, the model that we study can provide a most valuable alternative when addressing practical applications.

The use of performance indices of an ergodic nature can be criticised on the grounds that they result in highly non-unique optimal strategies. In particular, any two decision strategies that differ on an arbitrarily long, but finite, time period are associated with the same value of the performance criterion. However, the idea that long-term average criteria should be considered in connection with sustainable development applications addresses this issue because, in the presence of a transparent decision making process, it rules out speculation from the decision maker.

At this point, we should observe that ergodic stochastic optimal control currently has a well-developed body of theory. In particular, one should note major advances in

the field that include, restricting attention to continuous-time models, Kushner [K78], Karatzas [K83], Gatarek and Stettner [GS90], Borkar and Ghosh [BG88], Bensoussan and Frehse [BF92], Menaldi, Robin and Taksar [MRT92], Duncan, Maslowski and Pasik-Duncan [DMP98], Kurtz and Stockbridge [KS98], Borkar [B99], Kruk [K00], Sadowy and Stettner [SS02], the references therein, and others. Also, ergodic stochastic control with a pathwise rather than an expected performance criterion has recently attracted considerable interest in the literature, e.g., see Rotar [R91], Presman, Rotar and Taksar [PRT93], Dai Pra, Di Masi and Trivellato [DDT01], Dai Pra, Runggaldier and Tolloti [DRT04], and the references therein.

Chapter 2 is concerned with the problem of optimally stopping the one-dimensional Itô diffusion

$$dX_t = b(X_t) dt + \sigma(X_t) dW_t, \quad X_0 = x > 0.$$

Here, W is a standard one-dimensional Brownian motion, and b, σ are deterministic functions such that this SDE has a unique weak solution that is non-explosive and assumes values in the interval $]0, \infty[$. The objective of the discretionary stopping problem is to maximise the performance criterion

$$\mathbb{E}_x \left[e^{-\int_0^\tau r(X_s) ds} f(X_\tau) \right]$$

over all stopping times τ , where $r > 0$ is a given deterministic function. The payoff function f takes finite values and is increasing and piecewise constant, so its graph looks like a staircase with a finite number of steps. The contents of this chapter will appear in Bronstein, Hughston, Pistorius and Zervos [BHPZ06].

The simplest version of this problem, which arises when $b \equiv 0$ and $\sigma \equiv 1$, i.e., when X is a standard Brownian motion, and when f can take only two values, was solved by Salminen [S85] using Martin boundary theory. The more general version of Salminen's model that arises when X is a Brownian motion with drift was recently

solved by Dayanik and Karatzas [DK03, Section 6.7] using a new methodology for addressing general one-dimensional discretionary stopping problems by means of a new characterisation of excessive functions that they have developed.

The investigations undertaken here have been motivated by two classes of applications. The first of these is concerned with the pricing of digital options of American type. In this context, the diffusion X models the underlying asset price dynamics, and r can be interpreted as the interest rate (i.e., the short rate). The second application arises in scenario-based managerial decision making. In this context, the diffusion X is used to model the evolution of an uncertain economic environment, while the function f models the various discrete payoffs that can be obtained when action is triggered.

We have also been motivated by some general stochastic control theoretic issues; in particular, it is of interest to observe that the problem we study provides an example in which the so-called “principle of smooth fit”, which suggests that the value function of an optimal stopping problem should be C^1 , does not hold. Indeed, it turns out that the value function is not C^1 at all points that belong to the boundary of the stopping region as well as to the set of points at which f is discontinuous. This phenomenon has been observed by Salminen [S85], and by Dayanik and Karatzas [DK03]. One of the purposes of this paper is to offer a new way of addressing this issue by means of techniques based on the use of local times.

Chapter 1

Sequential Entry and Exit Decisions with an Ergodic Performance Criterion

1.1 Introduction

We consider an investment project that can be operated in two modes, say “active” and “passive”. When it is in its “active” mode, the project yields payoff at a rate that depends on the value of an underlying random economic indicator, such as a given commodity’s price or demand. We model this indicator by a general one-dimensional ergodic Itô diffusion

$$dX_t = b(X_t) dt + \sigma(X_t) dW_t, \quad X_0 = x \in \mathbb{R},$$

where W is a standard one-dimensional Brownian motion and $b, \sigma : \mathbb{R} \rightarrow \mathbb{R}$ are given deterministic functions. When the project is in its “passive” mode, it incurs losses that reflect, for example, maintenance costs. The transition of the project from one mode to the other one can be realised immediately at certain fixed costs. The sequence of

times at which the project's mode is changed constitutes a decision strategy that is determined by the project's management. The objective of the resulting optimisation problem is to maximise the pathwise performance criterion

$$\limsup_{T \rightarrow \infty} \frac{1}{T} \left[\int_0^T [Z_t h_1(X_t) + (1 - Z_t) h_0(X_t)] dt - \sum_{t \in [0, T[} [K_1 \mathbf{1}_{\{\Delta Z_t = 1\}} + K_0 \mathbf{1}_{\{\Delta Z_t = -1\}}] \right],$$

as well as the *expected* performance criterion

$$\limsup_{T \rightarrow \infty} \frac{1}{T} \mathbb{E}_x \left[\int_0^T [Z_t h_1(X_t) + (1 - Z_t) h_0(X_t)] dt - \sum_{t \in [0, T[} [K_1 \mathbf{1}_{\{\Delta Z_t = 1\}} + K_0 \mathbf{1}_{\{\Delta Z_t = -1\}}] \right],$$

that quantify the payoff flow associated with each switching strategy over the set of all admissible such strategies.

The chapter is organised as follows. Section 1.2 is concerned with the formulation of the investment project model that we study. In Section 1.3, we consider examples of stochastic dynamics for the underlying economic indicator that satisfy our assumptions, and we reformulate the optimisation problems that we solve to equivalent and simpler ones. In Section 1.4, we consider the associated dynamic programming equation, and we establish a verification theorem and an ergodic result that we use later. Finally, Section 1.5 is concerned with the solution to the optimisation problems considered.

1.2 Problem formulation

We consider an investment project that is operated within a random economic environment. We model this environment by means of a one-dimensional Itô diffusion. In particular, we assume that all randomness affecting the payoff flow resulting from the project's management is characterised by a state process X that satisfies the one-dimensional SDE

$$dX_t = b(X_t) dt + \sigma(X_t) dW_t, \quad X_0 = x \in \mathbb{R}, \quad (1.1)$$

where $b, \sigma : \mathbb{R} \rightarrow \mathbb{R}$ are given functions, and W is a standard one-dimensional Brownian motion. In practice, we can think of such an investment project as a unit that can produce a single commodity. In this context, the process X can be used to model an economic indicator, such as the commodity's demand, or the logarithm of the commodity's price.

We assume that the project can be operated in two distinct modes, say “active” and “passive”. The sequence of times at which the project's operating mode is switched from “active” to “passive” and vice versa presents a sequence of decisions made by the project's management. We assume that, when decided, the project's transition from one of its operating modes to the other one is realised instantaneously. To model a switching strategy adopted by the project's management, we use an adapted, finite variation, left-continuous process Z with values in $\{0, 1\}$ and we denote Z_0 by z . In particular, a choice of such a switching process Z represents a strategy that keeps the investment in its “active” operating mode when $Z_t = 1$, and in its “passive” mode whenever $Z_t = 0$. Also, the times at which the jumps of Z occur represent the discretionary times at which the project's mode is changed. The variable $Z_0 = z \in \{0, 1\}$ indicates the project's operating mode at time 0.

Throughout our analysis, we adopt a *weak formulation* point of view.

Definition 1 Given an initial condition $(x, z) \in \mathbb{R} \times \{0, 1\}$, a *switching strategy in the random economic environment modelled by (1.1)* is any collection $\mathbb{C}_{x,z} = (\mathbb{S}_x, Z)$ such that $\mathbb{S}_x = (\Omega, \mathcal{F}, \mathcal{F}_t, \mathbb{P}_x, W, X)$ is a weak solution of (1.1) and Z is an (\mathcal{F}_t) -adapted, finite variation, càglàd process with values in $\{0, 1\}$ and with $Z_0 = z$. We denote by $\mathcal{C}_{x,z}$ the set of all such switching strategies.

For a switching strategy to be well-defined, we adopt the following assumption.

Assumption 1 The deterministic functions $b, \sigma : \mathbb{R} \rightarrow \mathbb{R}$ satisfy the following condi-

tions:

$$\sigma^2(x) > 0, \quad \text{for all } x \in \mathbb{R}, \quad (1.2)$$

$$\text{for all } x \in \mathbb{R}, \text{ there exists } \varepsilon > 0 \text{ such that } \int_{x-\varepsilon}^{x+\varepsilon} \frac{1 + |b(s)|}{\sigma^2(s)} ds < \infty. \quad (1.3)$$

With regard to standard theory of one-dimensional diffusions (see Karatzas and Shreve [KS88] and Rogers and Williams [RW00]), (1.2) and (1.3) imply that (1.1) defines a regular one-dimensional diffusion. Moreover, the *scale function* p and the *speed measure* m given by

$$p(0) = 0 \quad \text{and} \quad p'(x) = \exp \left(-2 \int_0^x \frac{b(s)}{\sigma^2(s)} ds \right), \quad \text{for } x \in \mathbb{R}, \quad (1.4)$$

and

$$m(dx) = \frac{2}{\sigma^2(x)p'(x)} dx, \quad (1.5)$$

respectively, which characterise one-dimensional diffusions, such as the one associated with (1.1), are well-defined.

Assumption 2 The scale function p defined by (1.4) satisfies $\lim_{x \rightarrow -\infty} p(x) = -\infty$ and $\lim_{x \rightarrow \infty} p(x) = \infty$.

This assumption guarantees that the solution to (1.1) is *non-explosive* and *recurrent*, (see Proposition 5.5.22 in Karatzas and Shreve [KS88]).

With each switching strategy $\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}$, we associate the *pathwise* performance criterion

$$\begin{aligned} \tilde{J}^P(\mathbb{C}_{x,z}) &\equiv \tilde{J}^P(\mathbb{C}_{x,z}; h_1, h_0, K_1, K_0) \\ &:= \limsup_{T \rightarrow \infty} \frac{1}{T} \left[\int_0^T [Z_t h_1(X_t) + (1 - Z_t) h_0(X_t)] dt \right. \\ &\quad \left. - \sum_{t \in [0, T[} [K_1 \mathbf{1}_{\{\Delta Z_t = 1\}} + K_0 \mathbf{1}_{\{\Delta Z_t = -1\}}] \right], \end{aligned} \quad (1.6)$$

as well as the *expected* performance criterion

$$\begin{aligned}\tilde{J}^E(\mathbb{C}_{x,z}) &\equiv \tilde{J}^E(\mathbb{C}_{x,z}; h_1, h_0, K_1, K_0) \\ &:= \limsup_{T \rightarrow \infty} \frac{1}{T} \mathbb{E}_x \left[\int_0^T [Z_t h_1(X_t) + (1 - Z_t) h_0(X_t)] dt \right. \\ &\quad \left. - \sum_{t \in [0, T[} [K_1 \mathbf{1}_{\{\Delta Z_t = 1\}} + K_0 \mathbf{1}_{\{\Delta Z_t = -1\}}] \right],\end{aligned}\quad (1.7)$$

where $\Delta Z_t = Z_{t+} - Z_t$. Here, h_1 (resp., h_0) models the running payoff resulting from the project when this is operated in its “active” (resp., “passive”) mode. Also, K_0 and K_1 are the fixed costs associated with each switching of the project’s operating mode from “active” to “passive” and vice versa, respectively.

The first objective is to maximise \tilde{J}^P over $\mathcal{C}_{x,z}$ in a *pathwise* sense. In particular, we are going to prove that there exists a constant λ^* such that

$$\sup_{\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}} \tilde{J}^P(\mathbb{C}_{x,z}) = \lambda^*, \quad (1.8)$$

in the sense that, given any initial condition (x, z) ,

$$\text{for all } \mathbb{C}_{x,z} = (\mathbb{S}_x, Z) \in \mathcal{C}_{x,z}, \quad \tilde{J}^P(\mathbb{C}_{x,z}) \leq \lambda^*, \quad \mathbb{P}_x\text{-a.s.}, \quad (1.9)$$

and

$$\text{there exists } \mathbb{C}_{x,z}^* = (\mathbb{S}_x^*, Z^*) \in \mathcal{C}_{x,z} \text{ such that } \tilde{J}^P(\mathbb{C}_{x,z}^*) = \lambda^*, \quad \mathbb{P}_x^*\text{-a.s.} \quad (1.10)$$

The second objective is to maximise \tilde{J}^E over $\mathcal{C}_{x,z}$. In this case, we are going to show that

$$\sup_{\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}} \tilde{J}^E(\mathbb{C}_{x,z}) = \lambda^*, \quad (1.11)$$

where λ^* is the same constant as the one in (1.8). The following additional assumption ensures that the resulting optimisation problems are well-defined.

Assumption 3 The following conditions hold:

$$\sigma \text{ is locally bounded,} \quad (1.12)$$

$$\int_{-\infty}^{\infty} [1 + |h_1(s)| + |h_0(s)|] m(ds) < \infty, \quad (1.13)$$

$$h := h_1 - h_0 \text{ is strictly increasing,} \quad (1.14)$$

$$K := K_1 + K_0 > 0. \quad (1.15)$$

Assumption (1.12) is of a technical nature, and is satisfied in all cases of interest. Assumption (1.13) implies that the speed measure has finite total mass, which ensures the ergodicity of certain processes, such as the state process X . Furthermore, it is essential for the performance criteria that we consider to be well-defined and for the constant λ^* appearing in (1.8)–(1.11) to be a real number. With regard to an interpretation of the state process as an economic indicator, such as demand or a log-price, (1.14) is a natural assumption to make in practice. Indeed, increased demand/prices are plainly associated with increased running payoff values, which implies that the running payoff function h_1 associated with the “active” mode of the investment project should be an increasing function. On the other hand, it would be reasonable to assume that the running payoff function h_0 associated with the “passive” mode of the project is identically equal to a negative constant modelling running maintenance costs. These two observations provide the grounds for adopting (1.14) as an assumption. At this point, it is worth noting that the only reason for allowing h_0 to have a non-trivial dependence on the state process is because such a generalisation does not affect the complexity of our analysis, and can potentially be associated with other applications.

Finally, assumption (1.15) is essential for the well-posedness of the optimisation problem considered. Indeed, the possibility $K_1 + K_0 < 0$ is associated with arbitrarily large values of the performance criteria that can be achieved by a strategy involving

sufficiently rapid changes of the project's operational mode. However, even though we interpret the constants K_1 and K_0 as switching costs, we allow for the possibility that one of them is negative. With regard to economics considerations, this presents a degree of freedom that can be used to model a situation such as the one arising when the cost of switching the project from its "passive" mode to its "active" one is not totally sunk, but can be partially recovered by realising the reverse switching.

1.3 Examples and problem simplifications

If we interpret the state process X given by (1.1) as a log-price, the geometric Brownian motion that is widely used in finance as well as in the theory of real options as an asset price is not compatible with the assumptions that we have adopted in the previous section because its speed measure has infinite mass and, therefore, (1.13) is not satisfied. However, a number of asset price processes that are better suited to the commodity markets modelling, and have emerged in the context of the interest rate theory satisfy the requirements of our assumption. The following two examples are concerned with diffusions that are associated with the Black-Karasinski and the Cox-Ingersoll-Ross short rate models.

Example 1 In the context of the Black-Karasinski short rate model, the logarithm of an asset's price identifies with the Ornstein-Uhlenbeck process X given by the SDE

$$dX_t = k(\theta - X_t) dt + \sigma dW_t,$$

where k , θ and σ are strictly positive constants. It is straightforward to calculate that the scale function p and the speed measure m of this diffusion are given by

$$p'(x) = \exp\left(-\frac{2k\theta}{\sigma^2}x + \frac{k}{\sigma^2}x^2\right),$$

$$m(dx) = \frac{2}{\sigma^2} \exp\left(\frac{k\theta^2}{\sigma^2}\right) \exp\left(-\frac{k(x-\theta)^2}{\sigma^2}\right) dx,$$

respectively, and to verify that the corresponding requirements in Assumptions 1, 2 and 3 hold, provided that the functions h_0 and h_1 are suitably chosen.

Example 2 We can model the price of a given asset by means of the process e^X satisfying the SDE

$$de^{X_t} = k(\theta - e^{X_t}) dt + \sigma (e^{X_t})^l dW_t,$$

where k, θ, σ are strictly positive constants, and $l \in [\frac{1}{2}, 1]$, so that e^X is a so-called constant elasticity of variance (CEV) process. Note that, for $l = \frac{1}{2}$ and $k\theta - \frac{1}{2}\sigma^2 > 0$, e^X identifies with the short rate process in the Cox-Ingersoll-Ross model. With regard to Itô's formula, it is straightforward to check that

$$dX_t = \left(k\theta e^{-X_t} - \frac{1}{2}\sigma^2 e^{-2(1-l)X_t} - k \right) dt + \sigma e^{-(1-l)X_t} dW_t.$$

The scale function p and the speed measure m of this diffusion are given by

$$p'(x) = \exp \left(-\frac{2k\theta (e^{(1-2l)x} - 1)}{\sigma^2(1-2l)} + \frac{k(e^{2(1-l)x} - 1)}{\sigma^2(1-l)} + x \right),$$

$$m(dx) = \frac{2}{\sigma^2} \exp \left(\frac{2k\theta (e^{(1-2l)x} - 1)}{\sigma^2(1-2l)} - \frac{k(e^{2(1-l)x} - 1)}{\sigma^2(1-l)} + (1-2l)x \right) dx,$$

if $l \in]\frac{1}{2}, 1[$, by

$$p'(x) = \exp \left(\left[1 - \frac{2k\theta}{\sigma^2} \right] x + \frac{2k(e^x - 1)}{\sigma^2} \right),$$

$$m(dx) = \frac{2}{\sigma^2} \exp \left(\frac{2k\theta}{\sigma^2} x - \frac{2k(e^x - 1)}{\sigma^2} \right) dx,$$

if $l = \frac{1}{2}$, and by

$$p'(x) = \exp \left(\frac{2k\theta (e^{-x} - 1)}{\sigma^2} + \left[1 + \frac{2k}{\sigma^2} \right] x \right),$$

$$m(dx) = \frac{2}{\sigma^2} \exp \left(-\frac{2k\theta (e^{-x} - 1)}{\sigma^2} - \left[\frac{2k}{\sigma^2} + 1 \right] x \right) dx,$$

if $l = 1$. We can check that if $l \in]\frac{1}{2}, 1]$, or if $l = \frac{1}{2}$ and $k\theta - \frac{1}{2}\sigma^2 > 0$, then the requirements in Assumptions 1, 2 and 3 are all satisfied for appropriate choices of the functions h_0 and h_1 .

We now consider simplifications of the control problems formulated in Section 1.2 that we are going to solve. Fix any initial condition (x, z) and any switching strategy $\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}$. With reference to (1.13) in Assumption 3, the ergodic Theorems V.53.1 and V.54.5 in Rogers and Williams [RW00] imply

$$\begin{aligned} \lim_{T \rightarrow \infty} \frac{1}{T} \left[\int_0^T h_0(X_t) dt \right] &= \lim_{T \rightarrow \infty} \frac{1}{T} \mathbb{E}_x \left[\int_0^T h_0(X_t) dt \right] \\ &= \frac{1}{m(\mathbb{R})} \int_{-\infty}^{\infty} h_0(s) m(ds) < \infty. \end{aligned} \quad (1.16)$$

Also, it is straightforward to verify that, for any initial condition (x, z) fixed and any switching process Z , satisfying Definition 1, we have

$$\lim_{T \rightarrow \infty} \frac{1}{T} \sum_{t \in [0, T[} K_0 \Delta Z_t = \lim_{T \rightarrow \infty} \frac{1}{T} \mathbb{E}_x \left[\sum_{t \in [0, T[} K_0 \Delta Z_t \right] = 0. \quad (1.17)$$

Indeed, if Z models a strategy with a finite number of switchings, then Z has only a finite number of jumps and (1.17) follows immediately. Otherwise, recalling that Z is a finite variation process, with $\Delta Z_t \in \{-1, 1\}$, for all $t \geq 0$, and noticing that, any switching, will be followed by the reverse one, if it happens, we observe that, $\sum_{t \in [0, T[} \Delta Z_t \in \{-1, 0, 1\}$, for all $t \geq 0$, and (1.17) is satisfied.

Combining these observations with the calculation

$$\begin{aligned} &\tilde{J}^P(\mathbb{C}_{x,z}; h_1, h_0, K_1, K_0) \\ &= \limsup_{T \rightarrow \infty} \frac{1}{T} \left[\int_0^T Z_t [h_1(X_t) - h_0(X_t)] dt - \sum_{t \in [0, T[} (K_1 + K_0) \mathbf{1}_{\{\Delta Z_t = 1\}} \right. \\ &\quad \left. + \int_0^T h_0(X_t) dt + \sum_{t \in [0, T[} K_0 \Delta Z_t \right], \end{aligned}$$

we can see that

$$\tilde{J}^P(\mathbb{C}_{x,z}; h_1, h_0, K_1, K_0) = J^P(\mathbb{C}_{x,z}; h_1 - h_0, K_1 + K_0) + \frac{1}{m(\mathbb{R})} \int_{-\infty}^{\infty} h_0(s) m(ds),$$

where

$$\begin{aligned} J^P(\mathbb{C}_{x,z}) &\equiv J^P(\mathbb{C}_{x,z}; h, K) \\ &= \limsup_{T \rightarrow \infty} \frac{1}{T} \left[\int_0^T Z_t h(X_t) dt - \sum_{t \in [0, T[} K \mathbf{1}_{\{\Delta Z_t = 1\}} \right]. \end{aligned} \quad (1.18)$$

Similarly, we can use (1.16) and (1.17) to show that

$$\tilde{J}^E(\mathbb{C}_{x,z}; h_1, h_0, K_1, K_0) = J^E(\mathbb{C}_{x,z}; h_1 - h_0, K_1 + K_0) + \frac{1}{m(\mathbb{R})} \int_{-\infty}^{\infty} h_0(s) m(ds),$$

where

$$\begin{aligned} J^E(\mathbb{C}_{x,z}) &\equiv J^E(\mathbb{C}_{x,z}; h, K) \\ &= \limsup_{T \rightarrow \infty} \frac{1}{T} \mathbb{E}_x \left[\int_0^T Z_t h(X_t) dt - \sum_{t \in [0, T[} K \mathbf{1}_{\{\Delta Z_t = 1\}} \right]. \end{aligned} \quad (1.19)$$

It follows that, given any initial condition (x, z) , the problem of maximising the performance index \tilde{J}^P (resp., \tilde{J}^E) over $\mathcal{C}_{x,z}$ is *equivalent* to maximising the performance criterion J^P (resp., J^E) over $\mathcal{C}_{x,z}$.

1.4 The dynamic programming equation

We now consider the problem of maximising the performance indices J^P and J^E defined by (1.18) and (1.19), respectively, over all admissible switching strategies. To discover the optimal strategy, we look for a solution (w_1, w_0) to the Hamilton-Jacobi-Bellman (HJB) equation that takes the form of the following pair of coupled quasi-variational inequalities

$$\max \left\{ \frac{1}{2} \sigma^2(x) w_1''(x) + b(x) w_1'(x) + h(x), w_0(x) - w_1(x) \right\} = 0, \quad x \in \mathbb{R}, \quad (1.20)$$

$$\max \left\{ \frac{1}{2} \sigma^2(x) w_0''(x) + b(x) w_0'(x), w_1(x) - w_0(x) - K \right\} = 0, \quad x \in \mathbb{R}. \quad (1.21)$$

With regard to standard theory of stochastic control, the structure of these equations is closely related with the following considerations. Assuming that, at a given time t , the project is in its “passive” mode and the state process X assumes the value x , the project’s management is faced with two possible actions. The first one is to switch the project to its “active” mode and then continue optimally. Since the choice of such an action is not necessarily optimal, we can conclude that the value $\mathcal{V}_0(x)$ of the project in its “passive” mode is greater than or equal to the value $\mathcal{V}_1(x)$ of the project in its “active” mode minus the switching cost of K . This observation is associated with the inequality

$$\mathcal{V}_0(x) \geq \mathcal{V}_1(x) - K. \quad (1.22)$$

The second possible action is to leave the project in its “passive” mode, which is associated with a zero rate of payoff, over a short period of time, and then continue optimally. This second possibility, which may be suboptimal, is associated with the inequality

$$\frac{1}{2}\sigma^2(x)\mathcal{V}_0''(x) + b(x)\mathcal{V}_0'(x) \leq 0. \quad (1.23)$$

Since these are the only two actions that are available to the project’s management, one has to be optimal, so one of (1.22) or (1.23) must be satisfied with equality. However, these arguments *suggest* the structure of (1.21). The structure of (1.20) can be explained in a similar way.

The considerations above explaining the structure of the HJB equation (1.20)–(1.21) will play an important role in our investigation that leads to the solution of the optimisation problem considered. However, these ideas *have to be used with care* because the functions w_1 and w_0 neither identify with the value function of the optimisation problem, which, as it turns out, is identically equal to a constant, nor do they determine uniquely the optimal strategy. The latter observation is related with

the fact that, due to the “average” nature of the performance criterion considered, a suboptimal behaviour over an arbitrarily long, but finite, time period does not affect optimality.

The following result provides conditions that are sufficient for a switching strategy to be optimal.

Theorem 1 *Fix any initial condition $(x, z) \in \mathbb{R} \times \{0, 1\}$, consider the problem of maximising the performance indices J^P and J^E defined by (1.18) and (1.19), respectively, over the class of all admissible switching strategies $\mathcal{C}_{x,z}$, and suppose that Assumptions 1, 2 and 3 hold. Suppose that the functions $w_1, w_0 \in W_{\text{loc}}^{2,\infty}(\mathbb{R})$ satisfy (1.20)–(1.21), and there exists a constant C such that*

$$\sup_{x \in \mathbb{R}} |w_1(x) - w_0(x)| + \sup_{x \in \mathbb{R}} |\sigma(x) [w_1'(x) - w_0'(x)]|^2 < C. \quad (1.24)$$

Also, suppose that there exists a switching strategy $\mathbb{C}_{x,z}^* = (\mathbb{S}_x^*, Z^*)$ such that

$$\left[\frac{1}{2} \sigma^2(X_t^*) w_1''(X_t^*) + b(X_t^*) w_1'(X_t^*) + h(X_t^*) \right] Z_t^* = 0, \quad (1.25)$$

$$\left[\frac{1}{2} \sigma^2(X_t^*) w_0''(X_t^*) + b(X_t^*) w_0'(X_t^*) \right] (1 - Z_t^*) = 0, \quad (1.26)$$

Lebesgue-a.e., for all $t \geq 0$, \mathbb{P}_x^* -a.s., and

$$[w_1(X_t^*) - w_0(X_t^*) - K] \mathbf{1}_{\{\Delta Z_t^* = 1\}} = 0, \quad (1.27)$$

$$[w_0(X_t^*) - w_1(X_t^*)] \mathbf{1}_{\{\Delta Z_t^* = -1\}} = 0, \quad (1.28)$$

for all $t \geq 0$, \mathbb{P}_x^* -a.s.. Under these assumptions,

$$J^P(\mathbb{C}_{x,z}) \leq \limsup_{T \rightarrow \infty} \frac{1}{T} \left[-w_1(X_T) + \int_0^T \sigma(X_t) w_1'(X_t) dW_t \right], \quad \mathbb{P}_x\text{-a.s.}, \quad (1.29)$$

for all $\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}$, and

$$J^P(\mathbb{C}_{x,z}^*) = \limsup_{T \rightarrow \infty} \frac{1}{T} \left[-w_1(X_T^*) + \int_0^T \sigma(X_t^*) w_1'(X_t^*) dW_t^* \right], \quad \mathbb{P}_x^*\text{-a.s.} \quad (1.30)$$

Also,

$$\begin{aligned} \sup_{\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}} J^E(\mathbb{C}_{x,z}) &= J^E(\mathbb{C}_{x,z}^*) \\ &= \limsup_{T \rightarrow \infty} \frac{1}{T} \mathbb{E}_x^* \left[-w_1(X_T^*) + \int_0^T \sigma(X_t^*) w_1'(X_t^*) dW_t^* \right]. \end{aligned} \quad (1.31)$$

Proof. Fix any initial condition $(x, z) \in \mathbb{R} \times \{0, 1\}$, and consider any switching strategy $\mathbb{C}_{x,z} = (\mathbb{S}_x, Z) \in \mathcal{C}_{x,z}$. Using the generalised Itô's formula that is applicable for functions $w \in W_{\text{loc}}^{2,\infty}(\mathbb{R})$ (e.g., see Krylov [K80, Theorem 2.10.1]) and the integration by parts formula, we calculate

$$\begin{aligned} Z_T w_1(X_T) &= z w_1(x) + \int_0^T \left[\frac{1}{2} \sigma^2(X_t) w_1''(X_t) + b(X_t) w_1'(X_t) \right] Z_t dt \\ &\quad + \sum_{t \in [0, T[} w_1(X_t) \Delta Z_t + \int_0^T \sigma(X_t) w_1'(X_t) Z_t dW_t, \\ (1 - Z_T) w_0(X_T) &= (1 - z) w_0(x) + \int_0^T \left[\frac{1}{2} \sigma^2(X_t) w_0''(X_t) + b(X_t) w_0'(X_t) \right] (1 - Z_t) dt \\ &\quad - \sum_{t \in [0, T[} w_0(X_t) \Delta Z_t + \int_0^T \sigma(X_t) w_0'(X_t) (1 - Z_t) dW_t. \end{aligned}$$

With regard to the definitions (1.18) and (1.19) of the performance indices J^P and J^E , these calculations imply

$$J^P(\mathbb{C}_{x,z}) = \limsup_{T \rightarrow \infty} \frac{1}{T} \left[\mathcal{Q}_T^{(1)} + \mathcal{Q}_T^{(2)} + \mathcal{Q}_T^{(3)} + \mathcal{Q}_T^{(4)} + \mathcal{Q}_T^{(5)} \right], \quad (1.32)$$

$$J^E(\mathbb{C}_{x,z}) = \limsup_{T \rightarrow \infty} \frac{1}{T} \mathbb{E}_x \left[\mathcal{Q}_T^{(1)} + \mathcal{Q}_T^{(2)} + \mathcal{Q}_T^{(3)} + \mathcal{Q}_T^{(4)} + \mathcal{Q}_T^{(5)} \right], \quad (1.33)$$

where

$$\begin{aligned}
\mathcal{Q}_T^{(1)} &= -w_1(X_T) + \int_0^T \sigma(X_t) w_1'(X_t) dW_t, \\
\mathcal{Q}_T^{(2)} &= zw_1(x) + (1-z)w_0(x) - (1-Z_T)[w_0(X_T) - w_1(X_T)], \\
\mathcal{Q}_T^{(3)} &= \int_0^T \sigma(X_t) [w_0'(X_t) - w_1'(X_t)] (1-Z_t) dW_t, \\
\mathcal{Q}_T^{(4)} &= \int_0^T \left[\frac{1}{2} \sigma^2(X_t) w_1''(X_t) + b(X_t) w_1'(X_t) + h(X_t) \right] Z_t dt \\
&\quad + \int_0^T \left[\frac{1}{2} \sigma^2(X_t) w_0''(X_t) + b(X_t) w_0'(X_t) \right] (1-Z_t) dt, \\
\mathcal{Q}_T^{(5)} &= \sum_{t \in [0, T[} [w_1(X_t) - w_0(X_t) - K] \mathbf{1}_{\{\Delta Z_t = 1\}} \\
&\quad + \sum_{t \in [0, T[} [w_0(X_t) - w_1(X_t)] \mathbf{1}_{\{\Delta Z_t = -1\}}.
\end{aligned}$$

Assumption (1.24) implies

$$\lim_{T \rightarrow \infty} \frac{1}{T} \mathcal{Q}_T^{(2)} = \lim_{T \rightarrow \infty} \frac{1}{T} \mathbb{E}_x [\mathcal{Q}_T^{(2)}] = 0, \quad \mathbb{P}_x\text{-a.s.}, \quad (1.34)$$

and

$$\lim_{T \rightarrow \infty} \frac{1}{T} \mathcal{Q}_T^{(3)} = \lim_{T \rightarrow \infty} \frac{1}{T} \mathbb{E}_x [\mathcal{Q}_T^{(3)}] = 0, \quad \mathbb{P}_x\text{-a.s.} \quad (1.35)$$

The limits in (1.34) are indeed obvious. To see (1.35), we first observe that the quadratic variation of the local martingale $\mathcal{Q}^{(3)}$ satisfies

$$\langle \mathcal{Q}^{(3)} \rangle_T = \int_0^T [\sigma(X_t) [w_0'(X_t) - w_1'(X_t)] (1-Z_t)]^2 dt \leq CT, \quad (1.36)$$

where $C > 0$ is the constant appearing in (1.24). It follows that the stochastic integral $\mathcal{Q}^{(3)}$ is a square-integrable martingale, so

$$\mathbb{E}_x [\mathcal{Q}_T^{(3)}] = 0, \quad \text{for all } T \geq 0. \quad (1.37)$$

Furthermore, with regard to the Dambis, Dubins and Schwarz theorem (e.g., see Karatzas and Shreve [KS88, Theorem 3.4.6]), there exists a standard, one-dimensional

Brownian motion B defined on a possible extension of $(\Omega, \mathcal{F}, \mathbb{P}_x)$ such that $Q_T^{(3)} = B_{\langle Q^{(3)} \rangle_T}$. In view of this representation, the fact that $\lim_{T \rightarrow \infty} B_T/T = 0$, \mathbb{P}_x -a.s., and (1.36), we calculate

$$\begin{aligned} & \lim_{T \rightarrow \infty} \frac{1}{T} |Q_T^{(3)}| \\ & \leq \lim_{T \rightarrow \infty} \left[\frac{1}{T} |B_{\langle Q^{(3)} \rangle_T}| \mathbf{1}_{\{\langle Q^{(3)} \rangle_\infty < \infty\}} + \frac{C}{\langle Q^{(3)} \rangle_T} |B_{\langle Q^{(3)} \rangle_T}| \mathbf{1}_{\{\langle Q^{(3)} \rangle_\infty = \infty\}} \right] \\ & \leq \lim_{T \rightarrow \infty} \left[\frac{1}{T} \sup_{t \in [0, \langle Q^{(3)} \rangle_\infty]} |B_t| \mathbf{1}_{\{\langle Q^{(3)} \rangle_\infty < \infty\}} + \frac{C}{\langle Q^{(3)} \rangle_T} |B_{\langle Q^{(3)} \rangle_T}| \mathbf{1}_{\{\langle Q^{(3)} \rangle_\infty = \infty\}} \right] \\ & = 0. \end{aligned}$$

However, these inequalities and (1.37) imply (1.35).

To proceed further, we note that, since w_1, w_0 satisfy the HJB equation (1.20)–(1.21),

$$Q_T^{(4)} + Q_T^{(5)} \leq 0, \quad \text{for all } T \geq 0. \quad (1.38)$$

In view of this inequality, we can see that (1.32)–(1.33) and (1.34)–(1.35) imply (1.29) as well as

$$J^E(\mathbb{C}_{x,z}) \leq \limsup_{T \rightarrow \infty} \frac{1}{T} \mathbb{E}_x \left[-w_1(X_T) + \int_0^T \sigma(X_s) w_1'(X_s) dW_s \right]. \quad (1.39)$$

Finally, if $\mathbb{C}_{x,z}^*$ satisfies (1.25)–(1.28), then we can see that (1.38) holds with equality. Therefore, $J^P(\mathbb{C}_{x,z}^*)$ satisfies (1.30), while $J^E(\mathbb{C}_{x,z}^*)$ satisfies (1.39) with equality, and the proof is complete.

As we are going to see, the expressions on the right hand sides of (1.30) and (1.31) are both equal to the same constant. To this end, we are going to use the following result.

Lemma 2 *Let \mathbb{S}_x be a weak solution to the SDE (1.1), and let $f : \mathbb{R} \rightarrow \mathbb{R}$ be any measurable function satisfying $\int_{-\infty}^{\infty} |f(s)| m(ds) < \infty$. Also, suppose that the function*

$u \in W_{\text{loc}}^{2,\infty}(\mathbb{R})$ satisfies

$$\frac{1}{2}\sigma^2(x)u''(x) + b(x)u'(x) + f(x) = 0. \quad (1.40)$$

Then

$$\begin{aligned} \lim_{T \rightarrow \infty} \frac{1}{T} \left[-u(X_T) + \int_0^T \sigma(X_t)u'(X_t) dW_t \right] \\ = \lim_{T \rightarrow \infty} \frac{1}{T} \mathbb{E}_x \left[-u(X_T) + \int_0^T \sigma(X_t)u'(X_t) dW_t \right] \\ = \frac{1}{m(\mathbb{R})} \int_{-\infty}^{\infty} f(s) m(ds). \end{aligned} \quad (1.41)$$

Proof. With regard to Itô's formula,

$$u(X_T) = u(x) + \int_0^T \left[\frac{1}{2}\sigma^2(X_t)u''(X_t) + b(X_t)u'(X_t) \right] dt + \int_0^T \sigma(X_t)u'(X_t) dW_t.$$

Since u satisfies (1.40), it follows that

$$\frac{1}{T} \left[-u(X_T) + \int_0^T \sigma(X_t)u'(X_t) dW_t \right] = \frac{1}{T} \int_0^T f(X_t) dt - \frac{1}{T}u(x). \quad (1.42)$$

With regard to the ergodic Theorems V.53.1 and V.54.5 in Rogers and Williams [RW00], the limits

$$\lim_{T \rightarrow \infty} \frac{1}{T} \int_0^T f(X_t) dt \quad \text{and} \quad \lim_{T \rightarrow \infty} \frac{1}{T} \mathbb{E}_x \left[\int_0^T f(X_t) dt \right]$$

exist and are both equal to the last expression in (1.41). However, this observation and (1.42) establish the result. \square

1.5 The solution to the control problem

We can now solve the optimisation problems considered. Up to a point in our analysis below, we are going to consider solutions to the HJB equation (1.20)–(1.21) that are

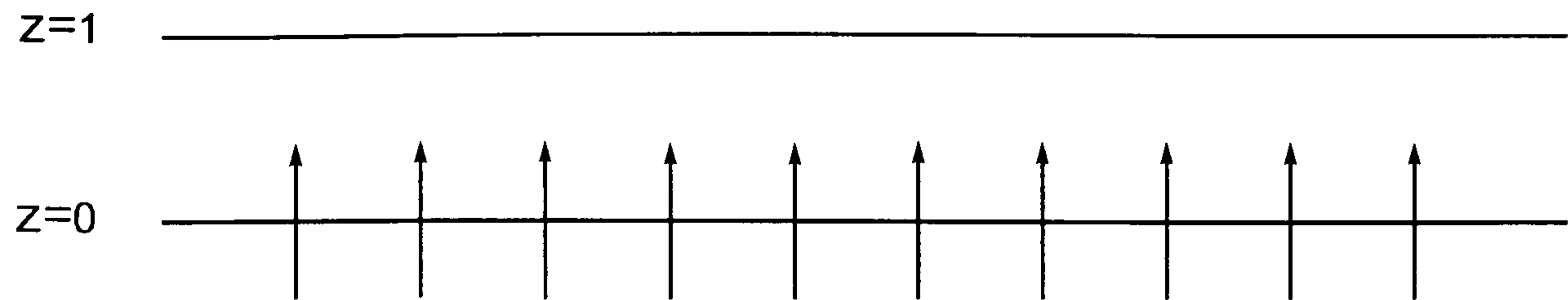


Figure 1.1: The case when it is optimal to keep the project in its “active” mode at all times. If the initial operating mode is “active”, then the management should take no action. Otherwise, switching immediately the project to its “active” mode is optimal.

associated with switching strategies that are suggested by intuitive economics considerations in connection with the dynamic programming ideas discussed at the beginning of Section 1.4.

A first possibility arises if the operation of the investment project in its “active” mode is very profitable, so that the optimal strategy should keep the project in its “active” mode at all times (for a pictorial representation, see Figure 1.1). In this case, the optimality ideas discussed at the beginning of Section 1.4 suggest that we should look for a solution (w_1, w_0) to the HJB equation (1.20)–(1.21) that is characterised by

$$\begin{aligned} \frac{1}{2}\sigma^2(x)w_1''(x) + b(x)w_1'(x) + h(x) &= 0, \quad \text{for all } x \in \mathbb{R}, \\ w_0(x) &= w_1(x) - K, \quad \text{for all } x \in \mathbb{R}. \end{aligned}$$

It is straightforward to verify that every solution to these equations is given by

$$\begin{aligned} w_1(x) &= w_0(x) + K \\ &= A + Bp(x) - \int_{x_0}^x p'(s) \int_{x_0}^s h(u) m(du) ds, \quad \text{for } x \in \mathbb{R}, \end{aligned} \quad (1.43)$$

where $A, B \in \mathbb{R}$ and $x_0 \in \mathbb{R}$ are constants. Here, p and m are the scale function and the speed measure defined by (1.4) and (1.5), respectively. Note that without any further conditions, w_1 and w_0 are not defined uniquely because they depend on the parameters

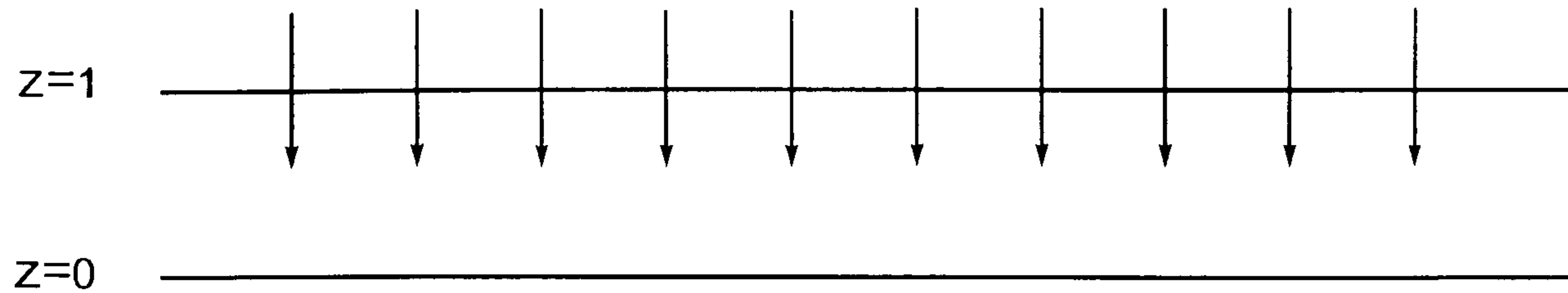


Figure 1.2: The case when it is optimal to keep the project in its “passive” mode at all times.

A and B. The following result is concerned with a necessary and sufficient condition for a choice of the functions w_1 and w_0 as in (1.43) to provide a solution to the HJB equation.

Lemma 3 *The functions w_1 and w_0 given by (1.43) satisfy the HJB equation (1.20)–(1.21) if and only if $h(x) \geq 0$, for all $x \in \mathbb{R}$.*

We collect in the Appendix the proofs of those results that are not developed in the text.

A similar case arises when it is optimal to always keep the project in its “passive” mode (see Figure 1.2). In this case, we look for a solution to (1.20)–(1.21) that satisfies

$$\begin{aligned} \frac{1}{2}\sigma^2(x)w_0''(x) + b(x)w_0'(x) &= 0, \quad \text{for all } x \in \mathbb{R}, \\ w_1(x) &= w_0(x), \quad \text{for all } x \in \mathbb{R}. \end{aligned}$$

Every such solution is given by

$$w_1(x) = w_0(x) = A + Bp(x), \quad \text{for } x \in \mathbb{R}, \tag{1.44}$$

for some constants $A, B \in \mathbb{R}$. A necessary and sufficient condition for these functions to satisfy the HJB equation is provided by the following result, the proof of which we omit because it is very similar to the proof of Lemma 3.

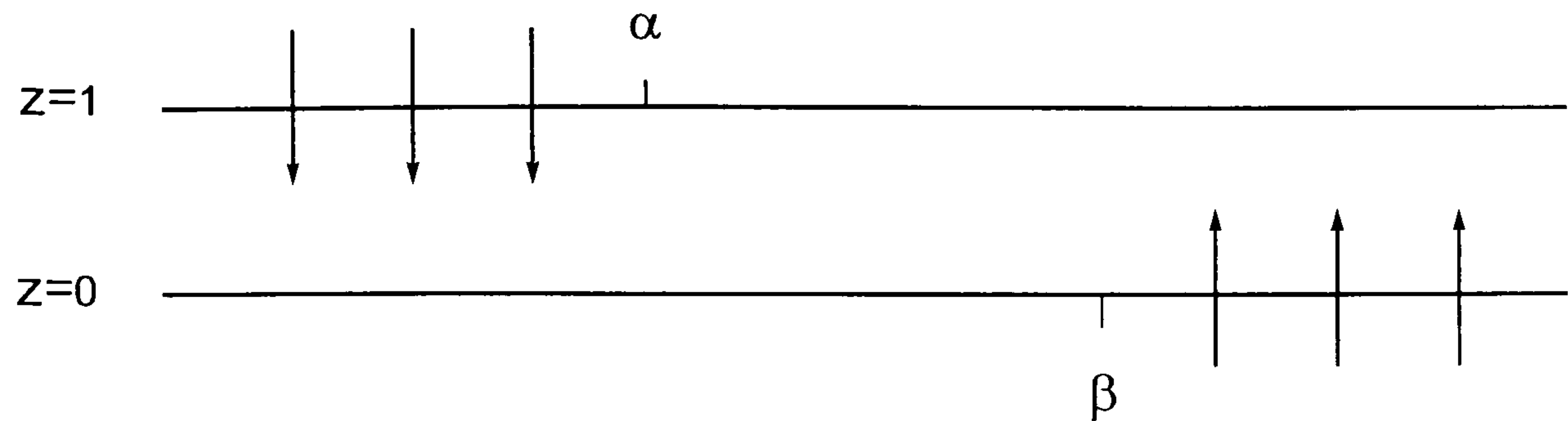


Figure 1.3: The case when it is optimal to switch sequentially.

Lemma 4 *The functions w_1 and w_0 given by (1.44) satisfy the HJB equation (1.20)–(1.21) if and only if $h(x) \leq 0$, for all $x \in \mathbb{R}$.*

A more interesting case arises when the optimal strategy involves a sequence of switchings. In such a case, we can guess that the optimal strategy takes the form that can be depicted by Figure 1.3, and can be described as follows. Recalling that the running payoff function h is strictly increasing, we should keep the investment in its “active” mode for as long as the state process assumes sufficiently large values, and we should switch it to its “passive” mode as soon as the state process hits a given “low” level that we are going to denote by $\alpha \in \mathbb{R}$. On the other hand, we should keep the project in its “passive” mode for as long as the state process assumes sufficiently low values, and we should switch it to its “active” mode as soon as the state process rises to an appropriate “high” level that we denote by $\beta \in \mathbb{R}$. Of course, for this strategy to be well-defined, we must have $\alpha < \beta$. In this case, we look for a solution to (1.20)–(1.21) that is characterised by

$$w_0(x) - w_1(x) = 0, \quad \text{for } x \in]-\infty, \alpha], \quad (1.45)$$

$$\frac{1}{2}\sigma^2(x)w_1''(x) + b(x)w_1'(x) + h(x) = 0, \quad \text{for } x \in]\alpha, \infty[, \quad (1.46)$$

$$\frac{1}{2}\sigma^2(x)w_0''(x) + b(x)w_0'(x) = 0, \quad \text{for } x \in]-\infty, \beta[, \quad (1.47)$$

$$w_1(x) - w_0(x) - K = 0, \quad \text{for } x \in [\beta, \infty[. \quad (1.48)$$

To specify the parameters α and β , we appeal to the so-called *principle of smooth fit* that dictates that the functions w_1 and w_0 should be C^1 at the free boundary points α and β , respectively. To this end, we first observe that every solution to (1.47) is given by

$$w_0(x) = A + Bp(x), \quad \text{for } x \in]-\infty, \beta[, \quad (1.49)$$

where A and B are constants. Given such a solution, we can see that the only C^1 function w_1 satisfying (1.45)–(1.46) is given by

$$w_1(x) = \begin{cases} A + Bp(x), & \text{if } x \in]-\infty, \alpha], \\ A + Bp(x) - \int_{\alpha}^x p'(s) \int_{\alpha}^s h(u) m(du) ds, & \text{if } x \in]\alpha, \infty[. \end{cases} \quad (1.50)$$

Moreover, (1.49) and (1.48) imply that w_0 is given by

$$w_0(x) = \begin{cases} A + Bp(x), & \text{if } x \in]-\infty, \beta[, \\ A + Bp(x) - K - \int_{\alpha}^x p'(s) \int_{\alpha}^s h(u) m(du) ds, & \text{if } x \in [\beta, \infty[. \end{cases} \quad (1.51)$$

Once again, we note that w_1 and w_0 are not unique. However, we observe that their difference, which is a function that will play a leading role in the investigation of this case, is uniquely defined. From this expression, we can see that w_0 will be C^1 if and only if the free boundary points $\alpha < \beta$ satisfy the system of equations

$$F(\alpha, \beta) = 0 \quad \text{and} \quad G(\alpha, \beta) = K, \quad (1.52)$$

where

$$F(\alpha, \beta) = \int_{\alpha}^{\beta} h(s) m(ds), \quad (1.53)$$

$$\begin{aligned} G(\alpha, \beta) &= - \int_{\alpha}^{\beta} p'(s) \int_{\alpha}^s h(u) m(du) ds \\ &= - \int_{\alpha}^{\beta} p'(s) F(\alpha, s) ds. \end{aligned} \quad (1.54)$$

For future reference, we note that

$$\begin{aligned} G(\alpha, \beta) &= - \int_{\alpha}^{\beta} \int_u^{\beta} p'(s) h(u) ds m(du) \\ &= \int_{\alpha}^{\beta} p(s) h(s) m(ds) - p(\beta) F(\alpha, \beta), \end{aligned} \quad (1.55)$$

the first identity following thanks to Fubini's theorem. In view of condition (1.13) in Assumption 3, $F(\alpha, \beta)$ is well-defined and finite for all choices of $\alpha, \beta \in [-\infty, \infty]$ such that $\alpha < \beta$. Also, $G(\alpha, \beta)$ is well-defined and finite for all $\alpha, \beta \in \mathbb{R}$ such that $\alpha < \beta$. However, we have to take care in all arguments involving limits such as $\lim_{\alpha \rightarrow -\infty} G(\alpha, \beta)$ or $\lim_{\beta \rightarrow \infty} G(\alpha, \beta)$ (see also the situation associated with Example 3 after Lemma 6 below).

Now, recalling that h is strictly increasing, we can see that there exist points $\alpha < \beta$ satisfying $F(\alpha, \beta) = 0$ only if

$$\lim_{x \rightarrow -\infty} h(x) < 0 < \lim_{x \rightarrow \infty} h(x), \quad (1.56)$$

which is a condition that complements the conditions required by the cases associated with Lemmas 3 and 4. For future reference, we also note that (1.56) and the assumption that h is strictly increasing imply that

$$\text{there exists a unique } \gamma \in \mathbb{R} \text{ such that } h(x) \begin{cases} < 0, & \text{for } x \in]-\infty, \gamma[, \\ > 0, & \text{for } x \in]\gamma, \infty[. \end{cases} \quad (1.57)$$

To proceed further, we define

$$\alpha^* = \sup \left\{ \alpha \in \mathbb{R} \mid F(\alpha, \infty) \equiv \int_{\alpha}^{\infty} h(s) m(ds) < 0 \right\}, \quad (1.58)$$

and

$$\beta^* = \inf \left\{ \beta \in \mathbb{R} \mid F(-\infty, \beta) \equiv \int_{-\infty}^{\beta} h(s) m(ds) > 0 \right\}, \quad (1.59)$$

with the usual conventions $\sup \emptyset = -\infty$ and $\inf \emptyset = \infty$. In the presence of (1.57), we can see that

$$-\infty \leq \alpha^* < \gamma < \beta^* \leq \infty. \quad (1.60)$$

Moreover, given this definition and the monotonicity of h , we can check that

$$\begin{aligned} \int_{-\infty}^{\infty} h(s) m(ds) < 0 &\Leftrightarrow (\alpha^* \in]-\infty, \gamma[\text{ and } \beta^* = \infty), \\ \int_{-\infty}^{\infty} h(s) m(ds) > 0 &\Leftrightarrow (\alpha^* = -\infty \text{ and } \beta^* \in]\gamma, \infty[), \end{aligned}$$

and

$$\int_{-\infty}^{\infty} h(s) m(ds) = 0 \Leftrightarrow (\alpha^* = -\infty \text{ and } \beta^* = \infty).$$

The following result provides a stepping stone for our subsequent analysis.

Lemma 5 *Suppose that (1.56) is true, and let γ , α^* and β^* be the points defined by (1.57), (1.58) and (1.59), respectively. There exists a unique, C^1 function $L :]\alpha^*, \gamma[\rightarrow]\gamma, \beta^*[$ such that $F(\alpha, L(\alpha)) = 0$. Moreover, this function satisfies*

$$\lim_{\alpha \downarrow \alpha^*} L(\alpha) = \beta^*, \quad \lim_{\alpha \uparrow \gamma} L(\alpha) = \gamma, \quad F(\alpha, x) \begin{cases} < 0, & \text{for all } x \in]\alpha, L(\alpha)[, \\ > 0, & \text{for all } x \in]L(\alpha), \infty[, \end{cases} \quad (1.61)$$

and

$$L'(\alpha) = \frac{\sigma^2(L(\alpha))p'(L(\alpha))h(\alpha)}{\sigma^2(\alpha)p'(\alpha)h(L(\alpha))} < 0. \quad (1.62)$$

We can now address the solvability of the system of equations given by (1.52).

Lemma 6 *The system of equations given by (1.52) has a solution (α, β) such that $-\infty < \alpha < \beta < \infty$ if and only if (1.56) is true and the constant G^* defined by*

$$G^* = \lim_{\alpha \downarrow \alpha^*} G(\alpha, L(\alpha)) > 0 \quad (1.63)$$

satisfies

$$G^* > K. \quad (1.64)$$

Under these conditions, the solution (α, β) is unique, and (1.50)–(1.51) define a solution (w_1, w_0) to the HJB equation (1.20)–(1.21) such that $w_1, w_0 \in W_{\text{loc}}^{2,\infty}(\mathbb{R})$. Moreover, if we consider the constant $K > 0$ as a variable, then

$$\alpha = \alpha(K) \text{ is strictly decreasing, } \lim_{K \downarrow 0} \alpha(K) = \gamma \text{ and } \lim_{K \uparrow G^*} \alpha(K) = \alpha^*, \quad (1.65)$$

$$\beta = \beta(K) \text{ is strictly increasing, } \lim_{K \downarrow 0} \beta(K) = \gamma \text{ and } \lim_{K \uparrow G^*} \beta(K) = \beta^*. \quad (1.66)$$

In view of the fact that $\lim_{\alpha \downarrow \alpha^*} L(\alpha) = \beta^*$, it is tempting to replace (1.64) by $G(\alpha^*, \beta^*) > K$, which would result in a simpler restatement of Lemma 6. However, the following example shows that such a condition is not always well-defined.

Example 3 Suppose that

$$b(x) \equiv 0, \quad \sigma(x) = \sqrt{1+x^4} \quad \text{and} \quad h(x) = \begin{cases} -x^2, & \text{if } x \leq 0, \\ x^2, & \text{if } x \geq 0. \end{cases}$$

For these choices of the problem's data, we can check that $p(x) = x$, all of the associated conditions in Assumptions 1, 2 and 3 hold, $\alpha^* = -\infty$ and $\beta^* = \infty$. Also, $\gamma = 0$, $L(\alpha) = -\alpha$, for all $\alpha < 0$, and, with regard to the expression for $G(\alpha, L(\alpha))$ provided by (1.75) in the Appendix,

$$G(\alpha, L(\alpha)) = 4 \int_0^{|\alpha|} \frac{s^3}{1+s^4} ds = \ln(1+\alpha^4), \quad \text{for } \alpha < \gamma = 0,$$

defines a strictly decreasing function. Since $\lim_{\alpha \rightarrow -\infty} G(\alpha, L(\alpha)) = \infty$, condition (1.64) is satisfied for any choice of the positive constant K . Now, with regard to (1.55), we calculate

$$G(\alpha, 0) = \frac{1}{2} \ln(1 + \alpha^4) \quad \text{and} \quad G(0, \beta) = \frac{1}{2} \ln(1 + \beta^4) - 2\beta \int_0^\beta \frac{s^2}{1 + s^4} ds,$$

which show that

$$\lim_{\alpha \downarrow \alpha^* \equiv -\infty} G(\alpha, \beta) = \infty, \quad \text{for all } \beta \in \mathbb{R},$$

and

$$\lim_{\beta \uparrow \beta^* \equiv \infty} G(\alpha, \beta) = -\infty, \quad \text{for all } \alpha \in \mathbb{R}. \quad (1.67)$$

However, these limits show that the expression $G(\alpha^*, \beta^*) \equiv G(-\infty, \infty)$ is *not* well-defined.

The cases considered up to now exhaust the range of candidates for the optimal strategy that arise from simple economic arguments (see Figures 1.1, 1.2 and 1.3). It is therefore tempting to assume that (1.64) is true for any positive value of K . However, the following example reveals that this is not in general the case.

Example 4 Suppose that

$$b(x) \equiv 0, \quad \sigma(x) = \sqrt{1 + x^4} \quad \text{and} \quad h(x) = \begin{cases} \zeta(x - 1), & \text{if } x \leq 1, \\ x - 1, & \text{if } x \geq 1, \end{cases}$$

where

$$\zeta = \frac{\int_1^\infty (s - 1)(1 + s^4)^{-1} ds}{\int_0^1 (1 - s)(1 + s^4)^{-1} ds}.$$

Plainly, all of the conditions in Assumptions 1, 2 and 3 are satisfied, $\alpha^* = 0$ and $\beta^* = \infty$. Furthermore, since

$$\lim_{\alpha \downarrow \alpha^*} G(\alpha, L(\alpha)) = 2\zeta \int_0^1 \frac{s(s - 1)}{1 + s^4} ds + 2 \int_1^\infty \frac{s(s - 1)}{1 + s^4} ds < \infty,$$

there exist values for K such that (1.64) is not satisfied.

When the assumptions of Lemmas 3, 4 and 6 are not satisfied, we cannot construct a solution to the HJB equation (1.20)–(1.21) that conforms with the heuristic considerations discussed at the beginning of Section 1.4 and that does not have a non-trivial transient nature. In this case, we indeed have to resort to a “variational” approach as in the proof of the following theorem that is our main result.

Theorem 7 *Fix any initial condition $(x, z) \in \mathbb{R} \times \{0, 1\}$, consider the problem of maximising the performance indices J^P and J^E defined by (1.18) and (1.19), respectively, over all admissible switching strategies in $\mathcal{C}_{x,z}$, and suppose that Assumptions 1, 2 and 3 are all satisfied. The following statements, in which, $\sup_{\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}} J^P(\mathbb{C}_{x,z})$ is understood as in (1.9)–(1.10), hold true:*

(i) *If $0 \leq h(x)$, for all $x \in \mathbb{R}$, then*

$$\begin{aligned} \sup_{\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}} J^P(\mathbb{C}_{x,z}; h, K) &= \sup_{\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}} J^E(\mathbb{C}_{x,z}; h, K) \\ &= \frac{1}{m(\mathbb{R})} \int_{-\infty}^{\infty} h(s) m(ds), \end{aligned} \quad (1.68)$$

and the switching strategy (S_x^, Z^*) , where S_x^* is a weak solution of (1.1) and Z^* is defined by $Z_t^* = z\mathbf{1}_{\{t=0\}} + \mathbf{1}_{\{t>0\}}$, is optimal.*

(ii) *If $h(x) \leq 0$, for all $x \in \mathbb{R}$, then*

$$\sup_{\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}} J^P(\mathbb{C}_{x,z}; h, K) = \sup_{\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}} J^E(\mathbb{C}_{x,z}; h, K) = 0, \quad (1.69)$$

and the switching strategy (S_x^, Z^*) , where S_x^* is a weak solution of (1.1) and Z^* is defined by $Z_t^* = z\mathbf{1}_{\{t=0\}}$, is optimal.*

(iii) *If $\lim_{x \rightarrow -\infty} h(x) < 0 < \lim_{x \rightarrow \infty} h(x)$ and (1.64) is true, then*

$$\begin{aligned} \sup_{\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}} J^P(\mathbb{C}_{x,z}; h, K) &= \sup_{\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}} J^E(\mathbb{C}_{x,z}; h, K) \\ &= \frac{1}{m(\mathbb{R})} \int_{\alpha}^{\infty} h(s) m(ds) \\ &= \frac{1}{m(\mathbb{R})} \int_{\beta}^{\infty} h(s) m(ds), \end{aligned} \quad (1.70)$$

where (α, β) is the unique solution of (1.52) derived in Lemma 6, and an optimal switching strategy can be constructed as in the proof below.

(iv) If $\lim_{x \rightarrow -\infty} h(x) < 0 < \lim_{x \rightarrow \infty} h(x)$ and (1.64) is not true, then

$$\begin{aligned} \sup_{\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}} J^P(\mathbb{C}_{x,z}; h, K) &= \sup_{\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}} J^E(\mathbb{C}_{x,z}; h, K) \\ &= 0 \vee \frac{1}{m(\mathbb{R})} \int_{-\infty}^{\infty} h(s) m(ds). \end{aligned} \quad (1.71)$$

In this case, if $\sup_{\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}} J(\mathbb{C}_{x,z}; h, K) > 0$ (resp., $\sup_{\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}} J(\mathbb{C}_{x,z}; h, K) = 0$), then a switching strategy that is optimal for case (i) (resp., case (ii)) above is optimal.

Proof. In each of the cases (i)–(iii), $w_1, w_0 \in W_{\text{loc}}^{2,\infty}(\mathbb{R})$. The validity of (1.24) in the verification Theorem 1 follows immediately in cases (i) and (ii), and can be verified in case (iii) by appealing to the local boundedness of σ^2 , (see (1.12) in Assumption 3), and to the fact that $w'_1 - w'_0$ is continuous with compact support. In cases (i)–(ii), the strategies postulated in the statement of the theorem clearly satisfy (1.25)–(1.28). With regard to case (iii), suppose that $z = 1$ and, given any initial condition $x \in \mathbb{R}$, let $\mathbb{S}_x^* = (\Omega^*, \mathcal{F}^*, \mathcal{F}_t^*, \mathbb{P}_x^*, W^*, X^*)$ be a weak solution of (1.1). If Z^* is the process defined by

$$Z_t^* = \mathbf{1}_{\{t=0\}} + \sum_{n=0}^{\infty} \mathbf{1}_{\{S_n < t \leq T_n\}},$$

where $S_0 = 0$ and the (\mathcal{F}_t^*) -stopping times T_n and S_n , $n \in \mathbb{N}^*$, are defined recursively by

$$\begin{aligned} T_n &= \inf \{t \geq S_n \mid X_t^* \leq \alpha\}, \quad n = 0, 1, \dots, \\ S_n &= \inf \{t \geq T_n \mid X_t^* \geq \beta\}, \quad n = 1, 2, \dots, \end{aligned}$$

then we can check that $(\mathbb{S}_x^*, Z^*) \in \mathcal{C}_{x,1}$, and (1.25)–(1.28) are satisfied. If $z = 0$, an admissible switching strategy satisfying (1.25)–(1.28) can be constructed in a similar way. These observations show that all of the requirements of Theorem 1 are satisfied

in cases (i)–(iii), which establishes (1.29), (1.30) and (1.31), as well as the optimality of the associated switching strategies.

Now, (1.68) and (1.69) follow immediately from (1.29)–(1.31) and Lemma 2. In case (iii), w_1 satisfies

$$\frac{1}{2}\sigma^2(x)w_1''(x) + b(x)w_1'(x) + \mathbf{1}_{] \alpha, \infty[}(x)h(x) = 0,$$

by construction. Combining this observation with (1.29)–(1.31) and Lemma 2, we can see that the second equality in (1.70) is true. The last equality in (1.70) follows from the first one and the fact that $F(\alpha, \beta) = 0$, where F is defined by (1.53).

To prove (iv), assume that $\lim_{x \rightarrow -\infty} h(x) < 0 < \lim_{x \rightarrow \infty} h(x)$ and that $G^* \in]0, \infty[$, where G^* is defined by (1.63). Also, fix any $K \geq G^*$, and denote by J either of the performance indices J^P or J^E . A simple inspection of (1.18) and (1.19) that define J^P and J^E , respectively, reveals that $J(\mathbb{C}_{x,z}; h, K_1) \leq J(\mathbb{C}_{x,z}; h, K_2)$, for all $K_1 > K_2$, for all $\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}$. It follows that, given any $\mathbb{C}_{x,z} \in \mathcal{C}_{x,z}$,

$$\begin{aligned} J(\mathbb{C}_{x,z}; h, K) &\leq J(\mathbb{C}_{x,z}; h, \hat{K}) \\ &\leq \frac{1}{m(\mathbb{R})} \int_{\alpha(\hat{K})}^{\infty} h(s) m(ds), \quad \text{for all } \hat{K} \in]0, G^*[, \end{aligned}$$

the second inequality following from case (iii) that we established above. In view of (1.65), the dominated convergence theorem, and the definition (1.58) of α^* , we can pass to the limit $\hat{K} \uparrow G^*$ in these inequalities to obtain

$$\begin{aligned} J(\mathbb{C}_{x,z}; h, K) &\leq \frac{1}{m(\mathbb{R})} \int_{\alpha^*}^{\infty} h(s) m(ds) \\ &= \begin{cases} \frac{1}{m(\mathbb{R})} \int_{-\infty}^{\infty} h(s) m(ds), & \text{if } \alpha^* = -\infty, \\ 0, & \text{if } \alpha^* > -\infty, \end{cases} \end{aligned} \tag{1.72}$$

for all $\mathbb{C}_{x,z} = (\mathbb{S}_x, Z)$. Now, if $\mathbb{C}_{x,z}^* = (\mathbb{S}_x^*, Z^*)$ is the optimal switching strategy considered in case (i) or case (ii) of this theorem, depending on whether $\alpha^* = -\infty$ or

$\alpha^* > -\infty$, then

$$J(\mathbb{C}_{x,z}^*; h, K) = \begin{cases} \frac{1}{m(\mathbb{R})} \int_{-\infty}^{\infty} h(s) m(ds), & \text{if } \alpha^* = -\infty, \\ 0, & \text{if } \alpha^* > -\infty, \end{cases}$$

which, combined with (1.72), establishes all of the claims made in case (iv), and the proof is complete. \square

To summarize our analysis, we observe that the following steps lead to the solution of the stochastic control problem considered. First, given b and σ , we calculate the scale function p and the speed measure m of the diffusion X (see (1.4) and (1.5), respectively). We then consider the function h given by (1.14) and we check whether condition (1.64) is satisfied or not. Checking (1.64) involves calculating first the constant α^* given by (1.58) and then the constant G^* defined by (1.63). Given this data, we decide on which is the qualitative form of an optimal strategy by checking the conditions separating the four cases of Theorem 7. Finally, we calculate the optimal value of λ and the optimal switching boundaries.

Remark 1 *It is worth noting that, although we have focused on conditions such as (1.64) that is expressed in terms of the point α^* defined by (1.58), we can indeed develop a totally symmetric and equivalent analysis based on conditions involving the point β^* defined by (1.59).*

1.6 Appendix: Proofs of selected results

Proof of Lemma 3. With regard to their construction, w_1 and w_0 satisfy (1.20)–(1.21) if and only if

$$w_0(x) - w_1(x) \leq 0, \quad \text{for all } x \in \mathbb{R}, \quad (1.73)$$

$$\frac{1}{2}\sigma^2(x)w_0''(x) + b(x)w_0'(x) \leq 0, \quad \text{for all } x \in \mathbb{R}. \quad (1.74)$$

Plainly, (1.73) is equivalent to $K \geq 0$, which is implied by Assumption (1.15). Also, we can check that (1.74) is equivalent to $h(x) \geq 0$, for all $x \in \mathbb{R}$, which completes the proof. \square

Proof of Lemma 5. Given $\alpha \in]\alpha^*, \gamma[$, we consider the function $\bar{F}_{[\alpha]} : [\alpha, \infty[\rightarrow \mathbb{R}$ that is defined by $\bar{F}_{[\alpha]}(\beta) = F(\alpha, \beta)$. The calculation

$$\bar{F}'_{[\alpha]}(\beta) = \frac{2h(\beta)}{\sigma^2(\beta)p'(\beta)} \begin{cases} < 0, & \text{if } \beta \in]\alpha, \gamma[, \\ > 0, & \text{if } \beta \in]\gamma, \infty[, \end{cases}$$

shows that $\bar{F}_{[\alpha]}$ is strictly decreasing in $] \alpha, \gamma[$ and strictly increasing in $] \gamma, \infty[$. Combining this observation with $\bar{F}_{[\alpha]}(\alpha) = 0$ and the definitions (1.58) and (1.59) of α^* and β^* , respectively, we can see that there exists a unique function $L :]\alpha^*, \gamma[\rightarrow]\gamma, \beta^*[$ such that $\bar{F}_{[\alpha]}(L(\alpha)) \equiv F(\alpha, L(\alpha)) = 0$ and (1.61) are true. Moreover, if $-\infty < \alpha^*$, then $F(\alpha, \beta) = 0$ has no solution $\beta \in]\alpha, \infty[$ if $\alpha \in]-\infty, \alpha^*]$. Finally, differentiation of $F(\alpha, L(\alpha)) = 0$ with respect to α yields (1.62), the inequality there following from (1.57) and the fact that $\alpha < \gamma < L(\alpha)$. \square

Proof of Lemma 6. In view of Lemma 5, the system of equations given by (1.52) has a unique solution (α, β) such that $-\infty < \alpha < \beta < \infty$ if and only if the equation $G(\alpha, L(\alpha)) = K$ has a unique solution $\alpha \in]\alpha^*, \gamma[$. Now, with regard to (1.55), we can see that

$$G(\alpha, L(\alpha)) = \int_{\alpha}^{L(\alpha)} p(s)h(s) m(ds). \quad (1.75)$$

Recalling the definition (1.5) of the speed measure m , this expression and (1.62) imply

$$\frac{d}{d\alpha} G(\alpha, L(\alpha)) = \frac{2h(\alpha)[p(L(\alpha)) - p(\alpha)]}{\sigma^2(\alpha)p'(\alpha)} < 0, \quad \text{for all } \alpha \in]\alpha^*, \gamma[,$$

the inequality following because $h(\alpha) < 0$ for $\alpha < \gamma$, $L(\alpha) > \alpha$, and p is strictly increasing. However, this calculation shows that the function $G(\cdot, L(\cdot)) :]\alpha^*, \gamma[\rightarrow \mathbb{R}$ is

strictly decreasing. Combining this observation with

$$\lim_{\alpha \uparrow \gamma} G(\alpha, L(\alpha)) = G(\gamma, \gamma) = 0,$$

which follows from (1.75) and the second limit in (1.61), we can conclude that the constant G^* defined by (1.63) is strictly positive and that the system of equations (1.52) has a unique solution of the required form if and only if (1.64) is true.

Now, in the presence of (1.56) and (1.64), suppose that the switching cost $K > 0$ is an independent variable, and consider the solution (α, β) of (1.52) as a function of K . The limits in (1.65) follow from the arguments that we used above in this proof to identify $\alpha = \alpha(K)$ with the solution to $G(\alpha, L(\alpha)) = K$. Also, the limits in (1.66) regarding $\beta = \beta(K) = L(\alpha(K))$ follow from the ones in (1.65) and the ones in (1.61). To establish the monotonicity properties of $\alpha(\cdot)$ and $\beta(\cdot)$, we first differentiate equation $F(\alpha(K), \beta(K)) = 0$ with respect to K to calculate

$$\beta'(K) = \frac{\sigma^2(\beta(K))p'(\beta(K))h(\alpha(K))}{\sigma^2(\alpha(K))p'(\alpha(K))h(\beta(K))}\alpha'(K). \quad (1.76)$$

Differentiating the equation $G(\alpha(K), \beta(K)) = K$ with respect to K , and using this expression, we obtain

$$\alpha'(K) = \frac{\sigma^2(\alpha(K))p'(\alpha(K))}{2h(\alpha(K))[p(\beta(K)) - p(\alpha(K))]} < 0,$$

the inequality following thanks to (1.57), and the facts that $\alpha(K) < \gamma < \beta(K)$ and p is strictly increasing. However, this inequality proves that $\alpha(\cdot)$ is strictly decreasing. Moreover, this calculation, combined with (1.76), implies $\beta'(K) > 0$, which proves that $\beta(\cdot)$ is strictly increasing.

To complete the proof, it remains to show that, assuming that (1.56) and (1.64) hold, (w_1, w_0) given by (1.50)–(1.51), where α and β are the unique solution to (1.52),

solve the HJB equation (1.20)–(1.21), which amounts to proving that

$$\frac{1}{2}\sigma^2(x)w_1''(x) + b(x)w_1'(x) + h(x) \leq 0, \quad \text{for } x < \alpha, \quad (1.77)$$

$$w_0(x) - w_1(x) \leq 0, \quad \text{for } x \geq \alpha, \quad (1.78)$$

$$w_1(x) - w_0(x) - K \leq 0, \quad \text{for } x \leq \beta, \quad (1.79)$$

$$\frac{1}{2}\sigma^2(x)w_0''(x) + b(x)w_0'(x) \leq 0, \quad \text{for } x > \beta. \quad (1.80)$$

By construction, (1.77) is equivalent to $h(x) \leq 0$, for $x < \alpha$, which is true in the light of (1.57) and the fact that $\alpha < \gamma$. Similarly, (1.80) is equivalent to $h(x) \geq 0$, for $x > \beta$, which is implied by (1.57) and the fact that $\beta > \gamma$.

Either of (1.78) with $x \geq \beta$ or (1.79) with $x \leq \alpha$ is equivalent to $-K \leq 0$, which is implied by (1.15) in Assumption 3. In view of (1.50)–(1.51) and (1.54), we can see that (1.78) and (1.79) for $\alpha \leq x \leq \beta$ will follow if we show that

$$0 \leq G(\alpha, x) \leq K, \quad \text{for } x \in [\alpha, \beta]. \quad (1.81)$$

In the light of (1.54) and the last assertion in (1.61), we can see that

$$\frac{\partial}{\partial x}G(\alpha, x) = -p'(x)F(\alpha, x) > 0, \quad \text{for } x \in]\alpha, \beta[,$$

which shows that the function $G(\alpha, \cdot)$ is strictly increasing in $] \alpha, \beta [$. However, if we combine this observation with the equalities $G(\alpha, \alpha) = 0$ and $G(\alpha, \beta) = K$, we can see that (1.81) is true, and the proof is complete. \square

Chapter 2

Discretionary Stopping of One-dimensional Itô Diffusions with a Staircase Payoff Function

2.1 Introduction

This chapter is concerned with the problem of optimally stopping the one-dimensional Itô diffusion

$$dX_t = b(X_t) dt + \sigma(X_t) dW_t, \quad X_0 = x > 0.$$

Here, W is a standard one-dimensional Brownian motion, and b, σ are deterministic functions such that (2.1) has a unique weak solution that is non-explosive and assumes values in the interval $]0, \infty[$. The objective of the discretionary stopping problem is to maximise the performance criterion

$$\mathbb{E}_x \left[e^{-\int_0^\tau r(X_s) ds} f(X_\tau) \right]$$

over all stopping times τ , where $r > 0$ is a given deterministic function. The payoff function f takes finite values and is increasing and piecewise constant, so its graph looks like a staircase with a finite number of steps.

2.2 The discretionary stopping problem

We consider a stochastic system, the state process X of which is modelled by the one-dimensional Itô diffusion

$$dX_t = b(X_t) dt + \sigma(X_t) dW_t, \quad X_0 = x > 0. \quad (2.1)$$

We impose conditions (ND)' and (LI)' in Karatzas and Shreve [KS88, Section 5.5.C]; these conditions are sufficient for (2.1) to have a weak solution that is unique in the sense of probability law. In particular, we impose the following assumption.

Assumption 4 The deterministic functions $b, \sigma :]0, \infty[\rightarrow \mathbb{R}$ satisfy the following conditions:

$$(ND)' : \quad \sigma^2(x) > 0, \quad \text{for all } x > 0, \quad (2.2)$$

and

$$(LI)' : \quad \text{for all } x > 0, \text{ there exists } \varepsilon > 0 \text{ such that } \int_{x-\varepsilon}^{x+\varepsilon} \frac{1 + |b(s)|}{\sigma^2(s)} ds < \infty. \quad (2.3)$$

Fix a constant $c > 0$ and let p_c and m_c be the scale function and the speed measure of the diffusion X , which are defined as in (1.4) and (1.5), respectively. Also, define

$$l_c(x) := \int_c^x p'_c(y) \int_c^y m_c(dz) dy.$$

With reference to Feller's test for explosions (see Karatzas and Shreve [KS88, Theorem 5.5.29]), we impose the following assumption.

Assumption 5 $\lim_{x \downarrow 0} l_c(x) = \lim_{x \rightarrow \infty} l_c(x) = \infty$.

This assumption guarantees that the diffusion X is non-explosive, i.e. the probability that the diffusion X hits either of the boundaries 0 or ∞ of its state space in finite time is zero.

Assumption 4 also guarantees that X is a regular diffusion, which means that X reaches any point in $]0, \infty[$ with strictly positive probability.

We adopt a weak formulation of the optimal stopping problem that we study:

Definition 2 Given an initial condition $x > 0$, a *stopping strategy* is any collection $\mathbb{S}_x = (\Omega, \mathcal{F}, \mathcal{F}_t, \mathbb{P}_x, W, X, \tau)$, where $(\Omega, \mathcal{F}, \mathcal{F}_t, \mathbb{P}_x, W, X)$ is a weak solution to (2.1) and τ is an (\mathcal{F}_t) -stopping time. We denote by \mathcal{S}_x the family of all stopping strategies associated with a given initial condition $x > 0$.

With each stopping strategy $\mathbb{S}_x \in \mathcal{S}_x$, we associate the performance criterion

$$J(\mathbb{S}_x) = \mathbb{E}_x [e^{-\Lambda_\tau} f(X_\tau)] , \quad (2.4)$$

where

$$\Lambda_t = \int_0^t r(X_s) ds. \quad (2.5)$$

The payoff function f appearing here is assumed in the present investigation to have the form of a *finite staircase*, given by

$$f(x) = K_0 \mathbf{1}_{]0, p_1[}(x) + \sum_{j=1}^{N-1} K_j \mathbf{1}_{[p_j, p_{j+1}[}(x) + K_N \mathbf{1}_{[p_N, \infty[},$$

where $0 < p_1 < \dots < p_N$ and $K_0 < K_1 < \dots < K_N$ are given constants. The objective of the discretionary stopping problem is to maximise J over \mathcal{S}_x . Accordingly, we define the value function

$$v(x) = \sup_{\mathbb{S}_x \in \mathcal{S}_x} J(\mathbb{S}_x). \quad (2.6)$$

We shall also need the following additional assumptions.

Assumption 6 σ^2 is locally bounded.

Assumption 7 There exists a constant $r_0 > 0$ such that $r(x) > r_0$, for all $x > 0$.

At this point, we should note that Assumption 7 and the fact that f is bounded imply that (2.4) is well-defined when the event $\{\tau = \infty\}$ has positive probability. Indeed, in this case, we assume that

$$e^{-\Lambda_\tau} f(X_\tau) \Big|_{\tau=\infty} := \lim_{t \rightarrow \infty} e^{-\Lambda_t} f(X_t) = 0.$$

2.3 The Hamilton-Jacobi-Bellman (HJB) equation

On the basis of standard theory of optimal stopping, we expect that the value function v should satisfy the HJB equation

$$\max\{\mathcal{L}v(x), f(x) - v(x)\} = 0, \quad \text{for } x > 0, \quad (2.7)$$

where the second order elliptic differential operator \mathcal{L} is defined by

$$\mathcal{L}v(x) = \frac{1}{2}\sigma^2(x)v''(x) + b(x)v'(x) - r(x)v(x).$$

It turns out that the value function v of our discretionary stopping problem, which is defined by (2.6), has discontinuities in its first derivative. Therefore, it does not suffice in the present situation merely to consider classical solutions to the HJB equation (2.7). For this reason, we consider candidates for v that are differences of convex functions; for a survey of the results needed here, see Revuz and Yor [RY94, Appendix 3]. In particular, we consider solutions to (2.7) in the following sense.

Definition 3 A function $w :]0, \infty[\rightarrow \mathbb{R}$ satisfies the HJB equation (2.7) if it can be expressed as the difference of two convex functions and (2.7) is true, Lebesgue-a.e., with $\hat{\mathcal{L}}$ in place of \mathcal{L} , where the operator $\hat{\mathcal{L}}$ is defined by

$$\hat{\mathcal{L}}w(x) = \frac{1}{2}\sigma^2(x)w''_{\text{ac}}(x) + b(x)w'_-(x) - r(x)w(x). \quad (2.8)$$

Here, w'_- is the left hand derivative of w . Also,

$$w''(dx) = w''_{\text{ac}}(x) dx + w''_s(dx) \quad (2.9)$$

is the Lebesgue decomposition of the second distributional derivative $w''(dx)$ of w into the measure $w''_{\text{ac}}(x) dx$ that is absolutely continuous with respect to the Lebesgue measure and the measure $w''_s(dx)$ which is mutually singular with the Lebesgue measure.

Following Zervos [Z03, Theorem 1], we can now establish conditions that are sufficient for optimality in our problem.

Theorem 8 *In the discretionary stopping problem formulated in Section 2, suppose that Assumptions 4–7 hold, and let $w :]0, \infty[\rightarrow \mathbb{R}$ be a solution to the HJB equation (2.7) in the sense of Definition 3 such that*

$$w \text{ is bounded,} \quad (2.10)$$

$$-w''_s(dx) \text{ is a positive measure} \quad (2.11)$$

and

$$\text{supp } w''_s(dx) \subseteq \mathcal{C}^c := \{x > 0 \mid w(x) = f(x)\}. \quad (2.12)$$

Then, $v = w$ and, given any initial condition $x > 0$, a stopping strategy

$$\mathbb{S}_x^* = (\Omega^*, \mathcal{F}^*, \mathcal{F}_t^*, \mathbb{P}_x^*, W^*, X^*, \tau^*), \quad (2.13)$$

where $(\Omega^*, \mathcal{F}^*, \mathcal{F}_t^*, \mathbb{P}_x^*, W^*, X^*)$ is a weak solution to (2.1) and

$$\tau^* = \inf \{t \geq 0 \mid X_t^* \in \mathcal{C}^c\} \quad (2.14)$$

is optimal.

Proof. Fix any initial condition $x > 0$ and any weak solution $(\Omega, \mathcal{F}, \mathcal{F}_t, \mathbb{P}_x, W, X)$ to (2.1). Using Itô-Tanaka formula (see Revuz and Yor [RY94, Theorem VI.1.5]), we obtain

$$w(X_t) = w(x) + \int_0^t b(X_s) w'_-(X_s) ds + \int_0^t \sigma(X_s) w'_-(X_s) dW_s + \frac{1}{2} \int_0^\infty L_t^a w''(da) \quad (2.15)$$

where L^a is the local time of the process X at level a . With reference to the Lebesgue decomposition (2.9) and the occupation times formula (see Revuz and Yor [RY94, Corollary VI.1.6]),

$$\int_0^\infty L_t^a w''_{ac}(a) da = \int_0^t \sigma^2(X_s) w''_{ac}(X_s) ds,$$

so (2.15) implies

$$w(X_t) = w(x) + \int_0^t \left[\frac{1}{2} \sigma^2(X_s) w''_{ac}(X_s) + b(X_s) w'_-(X_s) \right] ds + \int_0^t \sigma(X_s) w'_-(X_s) dW_s + A_t^w,$$

where

$$A_t^w = \frac{1}{2} \int_0^\infty L_t^a w''_s(da). \quad (2.16)$$

For future reference, observe that (2.11) implies

$$-A^w \text{ is a continuous, increasing process,} \quad (2.17)$$

because such a statement is true for local times. Now, using the integration by parts formula for semimartingales, we obtain

$$e^{-\Lambda_t} w(X_t) = w(x) + \int_0^t e^{-\Lambda_s} \hat{\mathcal{L}} w(X_s) ds + M_t + \int_0^t e^{-\Lambda_s} dA_s^w, \quad (2.18)$$

where M is the stochastic integral defined by

$$M_t = \int_0^t e^{-\Lambda_s} \sigma(X_s) w'_-(X_s) dW_s. \quad (2.19)$$

To proceed further, fix any admissible stopping strategy $S_x \in \mathcal{S}_x$, let (τ_m) be the sequence of (\mathcal{F}_t) -stopping times defined by

$$\tau_m = \inf \{t \geq 0 \mid X_t \notin [\tfrac{1}{m}, m]\}, \quad \text{for } m = 1, 2, \dots,$$

and note that $\lim_{m \rightarrow \infty} \tau_m = \infty$, \mathbb{P}_x -a.s., because X is non-explosive. With regard to the local boundedness of σ^2 and w'_- (see Assumption 6 and (2.10), respectively), and the uniform positivity of the discounting factor r (see Assumption 7), we can see that, given any $m \geq 1$, the stopped process M^{τ_m} , where M is the stochastic integral defined as in (2.19), has quadratic variation that satisfies

$$\begin{aligned} \mathbb{E}_x [\langle M^{\tau_m} \rangle_\infty] &= \mathbb{E}_x \left[\int_0^\infty \mathbf{1}_{\{s \leq \tau_m\}} [e^{-\Lambda_s} \sigma(X_s) w'_-(X_s)]^2 ds \right] \\ &\leq \frac{1}{2r_0} \sup_{x \in [\frac{1}{m}, m]} [\sigma(x) w'_-(x)]^2 \\ &< \infty, \end{aligned}$$

which implies that M^{τ_m} is a uniformly square integrable martingale. Therefore, $M_\tau^{\tau_m}$ is well-defined and Doob's optional sampling theorem implies that $\mathbb{E}_x [M_\tau^{\tau_m}] = 0$. In light of this observation and (2.18) above, we can see that

$$\begin{aligned} \mathbb{E}_x [e^{-\Lambda_{\tau \wedge \tau_m}} f(X_{\tau \wedge \tau_m})] &= w(x) + \mathbb{E}_x [e^{-\Lambda_{\tau \wedge \tau_m}} [f(X_{\tau \wedge \tau_m}) - w(X_{\tau \wedge \tau_m})]] \\ &\quad + \mathbb{E}_x \left[\int_0^{\tau \wedge \tau_m} e^{-\Lambda_s} \hat{\mathcal{L}} w(X_s) ds \right] + \mathbb{E}_x \left[\int_0^{\tau \wedge \tau_m} e^{-\Lambda_s} dA_s^w \right]. \end{aligned} \tag{2.20}$$

In view of (2.17) and the fact that w satisfies (2.7) in the sense of Definition 3, it follows that

$$\mathbb{E}_x [e^{-\Lambda_{\tau \wedge \tau_m}} f(X_{\tau \wedge \tau_m})] \leq w(x).$$

However, by passing to the limit $m \rightarrow \infty$ in this inequality using the dominated convergence theorem, we can see that $J(S_x) \leq w(x)$, which proves that $v(x) \leq w(x)$.

Now, let \mathbb{S}_x^* be the stopping strategy given by (2.13)–(2.14). Since the measure dL_t^{*a} is supported on the set $\{t \geq 0 \mid X_t^* = a\}$, the definition of τ^* implies

$$L_t^{*a} = 0, \quad \text{for all } t \in [0, \tau^*] \text{ and } a \in \mathcal{C}^c,$$

which, in view of (2.12) and (2.16), implies $A_t^{w*} = 0$, for all $t \leq \tau^*$. However, combining this observation and the definition of \mathbb{S}_x^* with (2.20) and the fact that the set $\{x > 0 \mid w(x) = f(x)\}$ is closed, which follows from the upper semicontinuity of f , we can see that

$$\mathbb{E}_x^* \left[e^{-\Lambda_{\tau^* \wedge \tau_m^*}^*} f(X_{\tau^* \wedge \tau_m^*}^*) \right] = \mathbb{E}_x^* \left[e^{-\Lambda_{\tau_m^*}^*} [f(X_{\tau_m^*}^*) - w(X_{\tau_m^*}^*)] \mathbf{1}_{\{\tau_m^* < \tau^*\}} \right] + w(x).$$

With regard to the boundedness of f and w , and the uniform positivity of the discounting factor r (see Assumption 7), we can pass to the limit $m \rightarrow \infty$ using the dominated convergence theorem, to conclude that $J(\mathbb{S}_x^*) = w(x)$, which, combined with the inequality $v(x) \leq w(x)$ that we have established above, proves that $v(x) = w(x)$ and that \mathbb{S}_x^* is an optimal strategy. \square

We shall also need the following result for the construction of an appropriate solution to the HJB equation (2.7) in the next section.

Lemma 9 *Suppose that Assumptions 4–7 hold, fix two constants $y, z \in [0, \infty]$ such that $y < z$, and suppose that the functions $g, h : [y, z] \rightarrow \mathbb{R}$ are differences of two convex functions and satisfy*

$$\hat{\mathcal{L}}g(x) = \hat{\mathcal{L}}h(x) = 0, \quad \text{for all } x \in]y, z[, \quad (2.21)$$

where $\hat{\mathcal{L}}$ is defined by (2.8),

$$g(y) \geq h(y) \text{ and } g(z) \geq h(z), \quad (2.22)$$

$$g'_- \text{ and } h'_- \text{ are both locally bounded,} \quad (2.23)$$

$$g''_s(dx) \equiv 0 \text{ and } h''_s(dx) \text{ is a positive measure.} \quad (2.24)$$

Then $h(x) \leq g(x)$, for all $x \in [y, z]$.

Proof. Fix any initial condition $x \in]y, z[$ and any weak solution $(\Omega, \mathcal{F}, \mathcal{F}_t, \mathbb{P}_x, W, X)$ to (2.1), and define

$$T = \inf \{t \geq 0 \mid X_t \notin]y, z[\}.$$

Also, to simplify the proof, assume that σ^2 , g'_- and h'_- are all bounded rather than just locally bounded: indeed, when $y = 0$ or $z = \infty$, a straightforward adaptation of the “localising” arguments deployed in the proof of Theorem 8 can be used to address the more general case. This assumption implies that the stochastic integral

$$t \mapsto \int_0^{t \wedge T} e^{-\Lambda_s} \sigma(X_s) [g'_-(X_s) - h'_-(X_s)] dW_s$$

is a uniformly integrable martingale. However, this observation, (2.21)–(2.22) and Itô’s formula (2.18) imply

$$0 \leq g(x) - h(x) + \mathbb{E}_x \left[\int_0^T e^{-\Lambda_s} dA_s^{g-h} \right], \quad (2.25)$$

where

$$\begin{aligned} A_t^{g-h} &= \frac{1}{2} \int_y^z L_t^a [g''_s - h''_s] (da) \\ &= -\frac{1}{2} \int_y^z L_t^a h''_s(da), \quad \text{for } t \leq T. \end{aligned}$$

Since $h''_s(dx)$ is a positive measure, the process $-A^{g-h}$ is increasing, so

$$\mathbb{E}_x \left[\int_0^T e^{-\Lambda_s} dA_s^{g-h} \right] \leq 0,$$

which, combined with (2.25) above, implies that $h(x) \leq g(x)$, and the proof is complete. \square

2.4 The solution to the discretionary stopping problem

We will solve the optimal stopping problem that we consider by constructing a solution to the HJB equation (2.7) that satisfies the requirements of Theorem 8. To this end, we first observe that every solution to the homogeneous ordinary differential equation (ODE)

$$\frac{1}{2}\sigma^2(x)w''(x) + b(x)w'(x) - r(x)w(x) = 0, \quad (2.26)$$

which is associated with (2.7) is given by

$$w(x) = A\varphi(x) + B\psi(x), \quad (2.27)$$

for some constants $A, B \in \mathbb{R}$. The functions ψ, φ are defined by

$$\psi(x) = \begin{cases} \mathbb{E}_x [e^{-\Lambda T_y}], & \text{for } x < y, \\ (\mathbb{E}_y [e^{-\Lambda T_x}])^{-1}, & \text{for } x \geq y, \end{cases} \quad (2.28)$$

$$\varphi(x) = \begin{cases} (\mathbb{E}_y [e^{-\Lambda T_x}])^{-1}, & \text{for } x < y, \\ \mathbb{E}_x [e^{-\Lambda T_y}], & \text{for } x \geq y, \end{cases} \quad (2.29)$$

respectively, for a given choice of $y > 0$. Here Λ is defined by (2.5), while T_x (resp., T_y) is the first hitting time of $\{x\}$ (resp., $\{y\}$). For future reference, we note that

$$\begin{aligned} \varphi \text{ and } \psi \text{ are both strictly positive and } C^1, \text{ their second derivative exists in the} \\ \text{classical sense, } \varphi \text{ is strictly decreasing and } \psi \text{ is strictly increasing.} \end{aligned} \quad (2.30)$$

Also, the Wronskian \mathcal{W} of φ and ψ , which identifies with the first derivative of the scale function of the diffusion X , is given by

$$\begin{aligned} \mathcal{W}(x) &:= \varphi(x)\psi'(x) - \varphi'(x)\psi(x) \\ &= \mathcal{W}(y) \exp \left(-2 \int_y^x \frac{b(s)}{\sigma^2(s)} ds \right), \quad \text{for } x > 0, \end{aligned} \quad (2.31)$$

for any given choice of $y > 0$. These results are known since several decades and can be found in various forms in several references, including Feller [F52], Breiman [B68], Itô and McKean [IM74], Karlin and Taylor [KT81], and Rogers and Williams [RW00]. Here, we follow the exposition in Johnson and Zervos [JZ06, Appendix], where analytic expressions for the functions φ and ψ are also derived when X is a geometric Brownian motion, a mean-reverting square-root process such as the one used in the Cox-Ingersoll-Ross interest rate model, an exponential Ornstein-Uhlenbeck process such as the one used in the Black-Karasinski interest rate model, or a geometric Ornstein-Uhlenbeck process.

Back to our optimal stopping problem, we conjecture that the value function satisfies the HJB equation (2.7) in the *classical sense* outside the set of the points at which the discontinuities of f occur, namely, inside the set $]0, \infty[\setminus \{p_1, \dots, p_N\}$. This conjecture and the intuitive idea that some of the points p_1, \dots, p_N (e.g., p_N) should belong to the stopping region \mathcal{C}^c of the discretionary stopping problem that we solve motivate a “stepwise” approach, the first objective of which is to solve the following two problems.

Problem 1 Given constants $0 < y < z$ and $K < L$, find a continuous function $\tilde{w} : [y, z] \rightarrow \mathbb{R}$ that is a classical solution to (2.7) with $f(x) = K$, for $x \in]y, z[$, and satisfies the boundary conditions

$$\tilde{w}(y) = K \quad \text{and} \quad \tilde{w}(z) = L.$$

Problem 2 Given constants $z > 0$ and $K < L$, find a continuous, *bounded* function $\tilde{w} : [0, z] \rightarrow \mathbb{R}$ that is a classical solution to (2.7) with $f(x) = K$, for $x \in]0, z[$, and satisfies the boundary conditions

$$\tilde{w}(0) \geq K \quad \text{and} \quad \tilde{w}(z) = L.$$

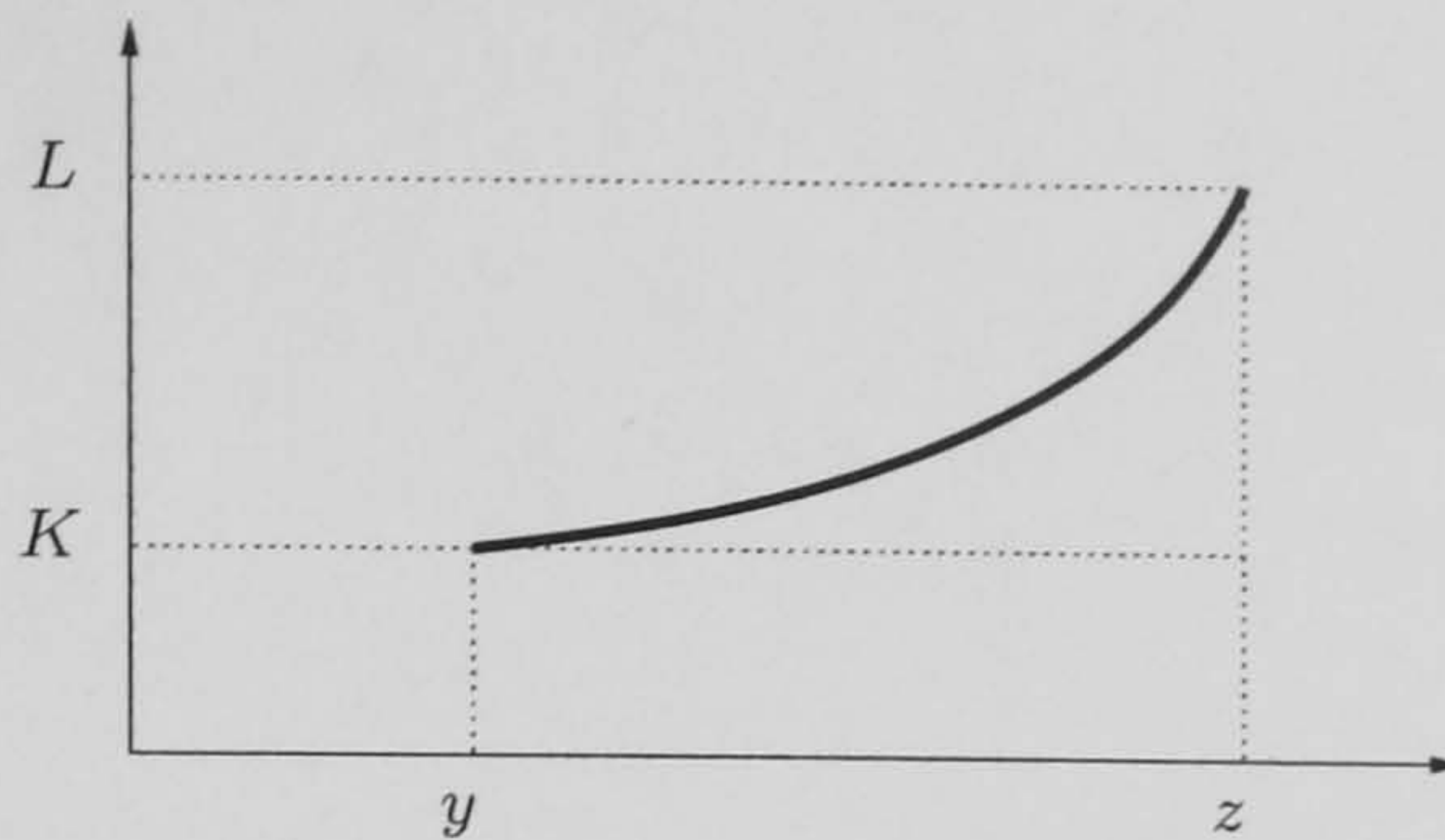


Figure 2.1: Graph of the first possible solution \tilde{w} to the HJB equation (2.7) that satisfies the boundary conditions $\tilde{w}(y) = K$ and $\tilde{w}(z) = L > K$ when $f \equiv K$ and the independent variable x takes values in the interval $]y, z[$, for $0 < y < z$ (Problem 1).

The solution to Problem 1, is associated with two qualitatively different possibilities. The first one arises when \tilde{w} satisfies the ODE (2.26) for all $x \in]y, z[$, in which case, \tilde{w} is given by

$$\tilde{w}(x) = \begin{cases} K, & \text{for } x = y, \\ A\varphi(x) + B\psi(x), & \text{for } x \in]y, z[, \\ L, & \text{for } x = z, \end{cases} \quad (2.32)$$

where A and B are constants (see Figure 2.1). The continuity of \tilde{w} at the boundary of $[y, z]$ yields a linear system of two equations for the unknowns A and B , the solution of which is given by

$$A = \left(\frac{L}{\psi(z)} - \frac{K}{\psi(y)} \right) \left(\frac{\varphi(z)}{\psi(z)} - \frac{\varphi(y)}{\psi(y)} \right)^{-1}, \quad (2.33)$$

$$B = \left(\frac{L}{\varphi(z)} - \frac{K}{\varphi(y)} \right) \left(\frac{\psi(z)}{\varphi(z)} - \frac{\psi(y)}{\varphi(y)} \right)^{-1}. \quad (2.34)$$

Lemma 10 *The function \tilde{w} defined by (2.32), where A and B are given by (2.33) and (2.34), respectively, provides a solution to Problem 1 if and only if*

$$\frac{\psi'(y)}{\varphi'(y)} \leq \frac{L\psi(y) - K\psi(z)}{L\varphi(y) - K\varphi(z)}. \quad (2.35)$$

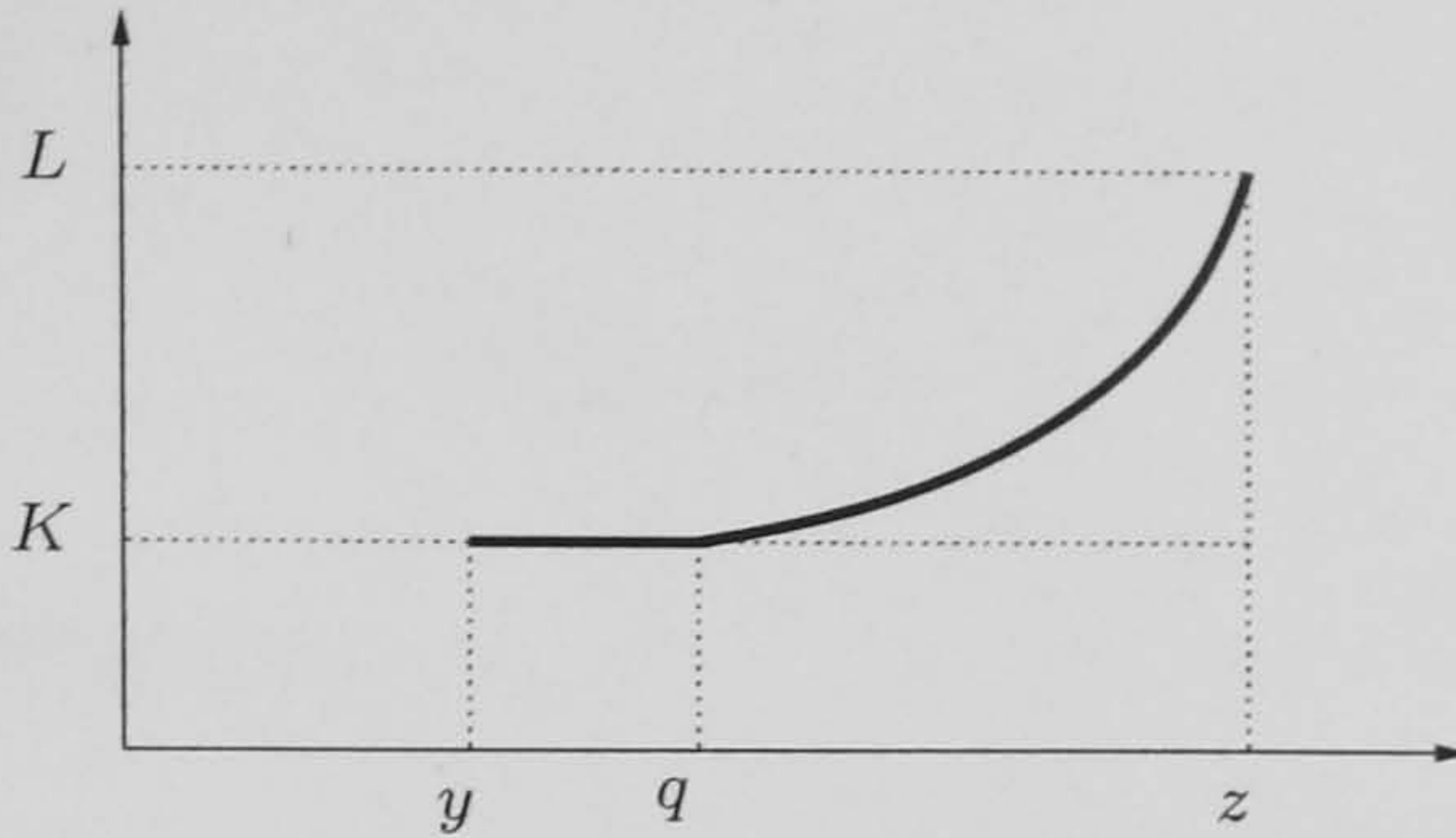


Figure 2.2: Graph of the second possible solution \tilde{w} to the HJB equation (2.7) that satisfies the boundary conditions $\tilde{w}(y) = K$ and $\tilde{w}(z) = L > K$ when $f \equiv K$ and the independent variable x takes values in the interval $]y, z[$, for $0 < y < z$ (Problem 1).

We collect in the Appendix the proofs of those results that are not fully developed in the text.

The second possibility arises when there is a point $q \in]y, z[$ such that $\tilde{w}(x) = K$ for $x \in [y, q]$, and \tilde{w} satisfies the ODE (2.26) for $x \in]q, z[$, which is associated with

$$\tilde{w}(x) = \begin{cases} K, & \text{for } x \in [y, q], \\ A\varphi(x) + B\psi(x), & \text{for } x \in]q, z[, \\ L, & \text{for } x = z, \end{cases} \quad (2.36)$$

where A and B are constants (see Figure 2.2). To determine A , B and the free boundary point q , we appeal to the requirement that \tilde{w} should satisfy (2.7) in the classical sense in $]y, z[$, which implies that \tilde{w} should be C^1 at q , and to the boundary condition $\tilde{w}(z) = L$. It is straightforward to see that the resulting system of equations is equivalent to the expressions

$$A = \left(\frac{L}{\psi(z)} - \frac{K}{\psi(q)} \right) \left(\frac{\varphi(z)}{\psi(z)} - \frac{\varphi(q)}{\psi(q)} \right)^{-1}, \quad (2.37)$$

$$B = \left(\frac{L}{\varphi(z)} - \frac{K}{\varphi(q)} \right) \left(\frac{\psi(z)}{\varphi(z)} - \frac{\psi(q)}{\varphi(q)} \right)^{-1}, \quad (2.38)$$

and the algebraic equation

$$F(q) = 0, \quad (2.39)$$

where the function F is defined by

$$F(x) = -[L\psi(x) - K\psi(z)] + [L\varphi(x) - K\varphi(z)] \frac{\psi'(x)}{\varphi'(x)}, \quad \text{for } x \in [y, z[. \quad (2.40)$$

Lemma 11 *Given any $y > 0$, equation (2.39) has a solution $q \in]y, z[$ if and only if*

$$\frac{\psi'(y)}{\varphi'(y)} > \frac{L\psi(y) - K\psi(z)}{L\varphi(y) - K\varphi(z)}. \quad (2.41)$$

If this condition is satisfied, then the solution q to (2.39) is unique and the function \tilde{w} defined by (2.36), where A and B are given by (2.37) and (2.38), respectively, solves Problem 1.

Now, let us consider Problem 2, which is again associated with two qualitatively different solutions. Since $\lim_{x \downarrow 0} \varphi(x) = \infty$, which follows from the definition (2.29) of φ and the assumption that X is non-explosive,

$$\tilde{w}(x) = \frac{L}{\psi(z)}\psi(x), \quad \text{for } x \in [0, z], \quad (2.42)$$

is the appropriate choice for \tilde{w} that corresponds to Lemma 10 because it is the only bounded solution to the ODE (2.26) that satisfies the boundary condition $\tilde{w}(z) = L$. With regard to the fact that ψ is strictly increasing and positive, it is straightforward to see that this choice indeed provides the solution to Problem 2 if $L\psi(0) \geq K\psi(z)$, where $\psi(0) := \lim_{x \downarrow 0} \psi(x)$ (see also Figure 2.3). When the problem's data are such that $L\psi(0) < K\psi(z)$, which can be true only if $K > 0$, we are faced with the possibility for the solution to Problem 2 to be as in Lemma 11 (see also Figure 2.4).

Lemma 12 *Equation (2.39) has a unique solution $q \in]0, z[$ if and only if $L\psi(0) < K\psi(z)$. Moreover, the following two statements are true:*

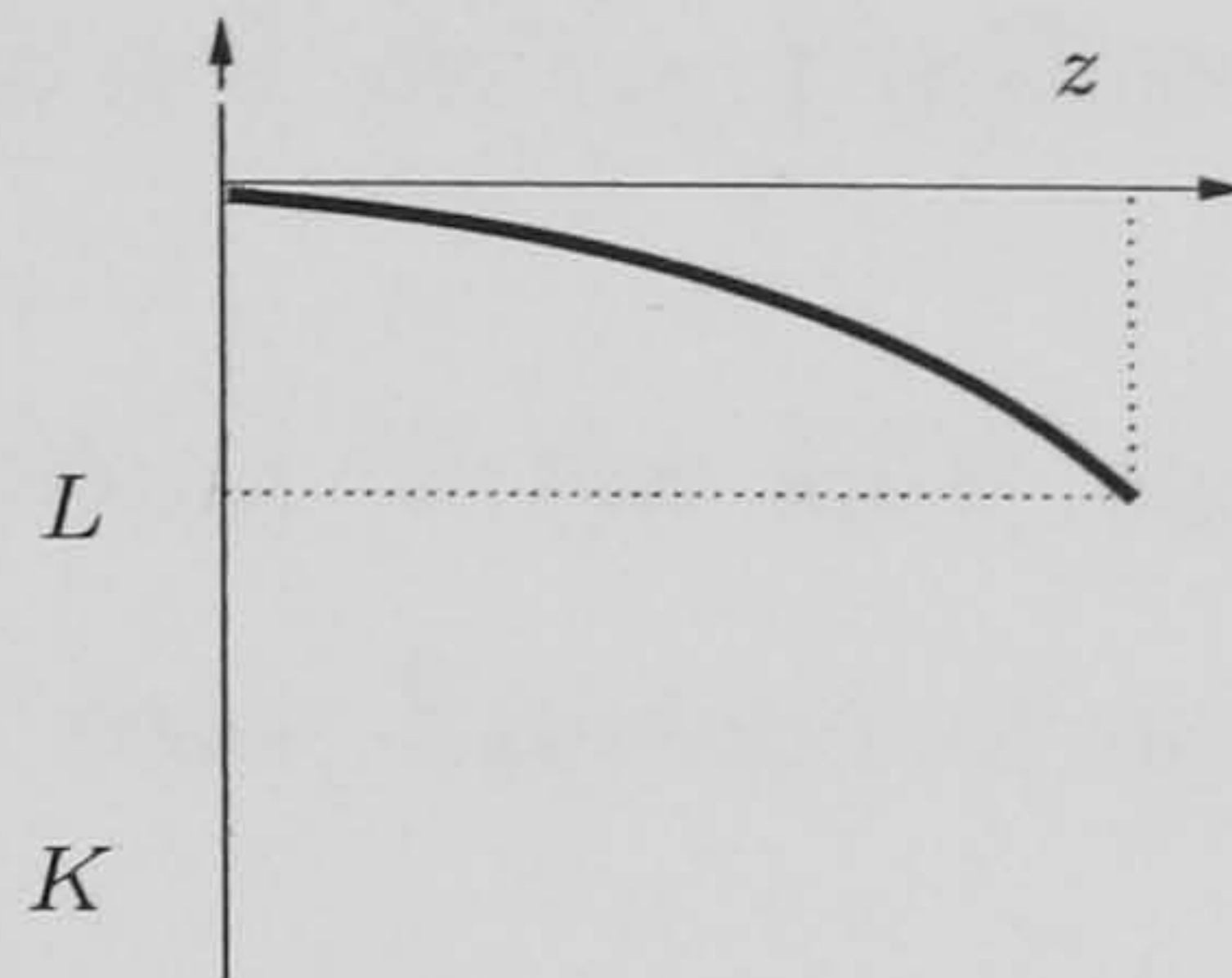


Figure 2.3: Graph of the first possible solution \tilde{w} to the HJB equation (2.7) that satisfies the boundary conditions $\tilde{w}(0) \geq K$ and $\tilde{w}(z) = L > K$ when $f \equiv K$ and the independent variable x takes values in the interval $]0, z[$, for $z > 0$ (Problem 2). Here, we illustrate the case when $K < L < 0$.

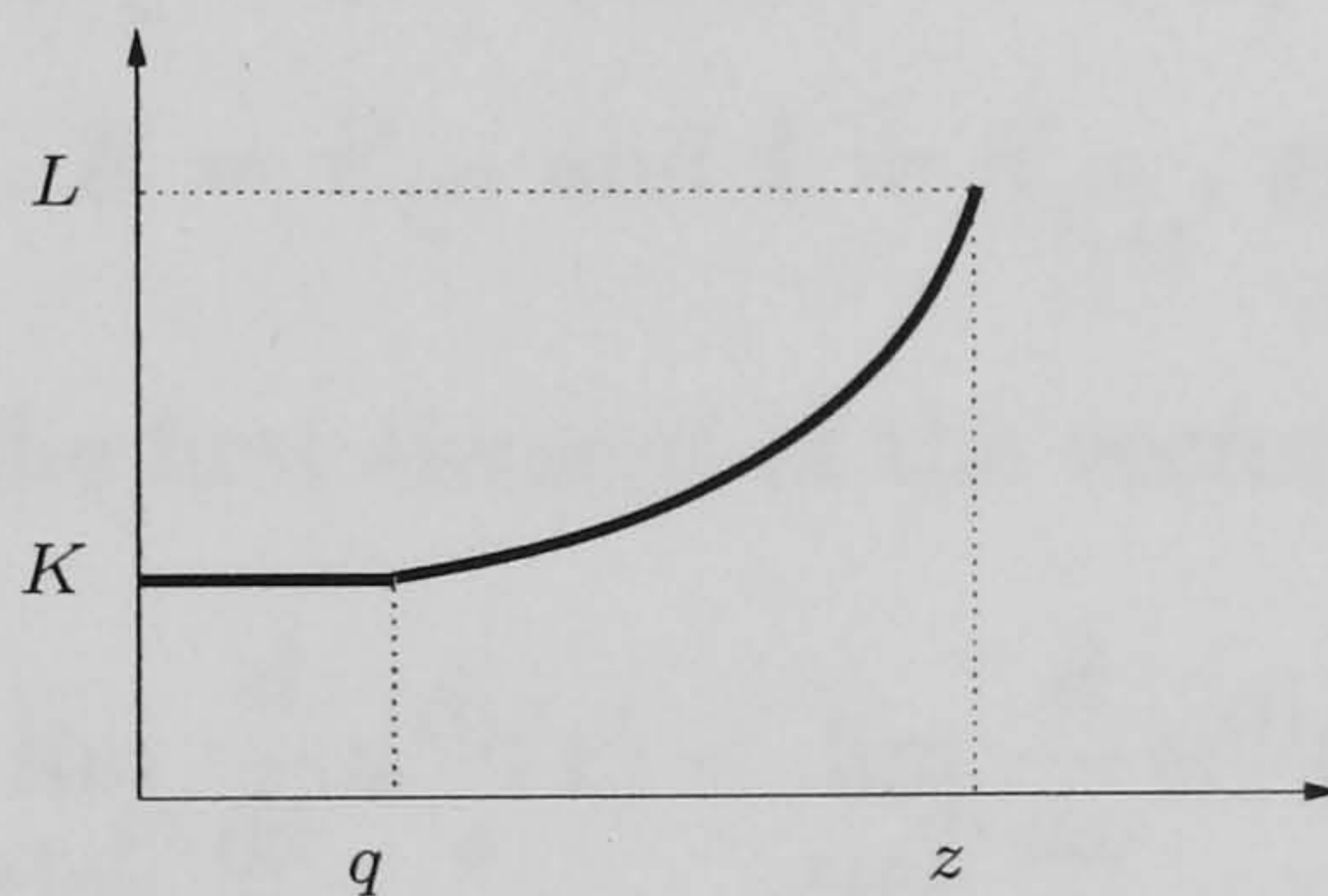


Figure 2.4: Graph of the second possible solution \tilde{w} to the HJB equation (2.7) that satisfies the boundary conditions $\tilde{w}(0) \geq K$ and $\tilde{w}(z) = L > K$ when $f \equiv K$ and the independent variable x takes values in the interval $]0, z[$, for $z > 0$ (Problem 2).

- (a) If $L\psi(0) \geq K\psi(z)$, then (2.42) provides a solution to Problem 2.
- (b) If $L\psi(0) < K\psi(z)$, then the function \tilde{w} defined by (2.36)–(2.38), where q is the unique solution to (2.39), with $y = 0$, solves Problem 2.

We can now construct a solution to the HJB equation (2.7) in the sense of Definition 3 that identifies with the value function of our discretionary stopping problem using the following algorithm.

Step 1 Set $l = 0$ and define the N -dimensional vectors

$$i^{(l)} = (1, 2, \dots, N-1, N) \quad \text{and} \quad \rho^{(l)} = (p_1, p_2, \dots, p_{N-1}, p_N).$$

Step 2 Define the function $w^{(l)} :]0, \infty[\rightarrow \mathbb{R}$ by

$$w^{(l)}(x) = w_0^{(l)}(x) \mathbf{1}_{]0, \rho_1^{(l)}[}(x) + \sum_{j=1}^{\dim i^{(l)} - 1} w_j^{(l)}(x) \mathbf{1}_{[\rho_j^{(l)}, \rho_{j+1}^{(l)}[}(x) + K_N \mathbf{1}_{[p_N, \infty[},$$

where $w_0^{(l)}$ is the solution to Problem 2 with $z = \rho_1^{(l)}$, $K = K_0$ and $L = K_{i_1^{(l)}}$, given by Lemma 12, while, for $j = 1, \dots, \dim i^{(l)} - 1$, $w_j^{(l)}$ is the solution to Problem 1 with $y = \rho_j^{(l)}$, $z = \rho_{j+1}^{(l)}$, $K = K_{i_j^{(l)}}$ and $L = K_{i_{j+1}^{(l)}}$, given by Lemmas 10 and 11.

Step 3 Let m be index of the first element of the vector $i^{(l)}$ such that

$$\lim_{x \uparrow \rho_m^{(l)}} \frac{d}{dx} w^{(l)}(x) < \lim_{x \downarrow \rho_m^{(l)}} \frac{d}{dx} w^{(l)}(x),$$

is true. Or equivalently, such that

$$(w^{(l)})''_s(\{\rho_m^{(l)}\}) > 0,$$

is satisfied. If no such index exists, then set $w = w^{(l)}$ and STOP. Otherwise, let $i^{(l+1)}$ and $\rho^{(l+1)}$ be the vectors obtained by deleting the m -th entry of the vectors $i^{(l)}$ and $\rho^{(l)}$, respectively, set $l = l + 1$, and go back to Step 2.

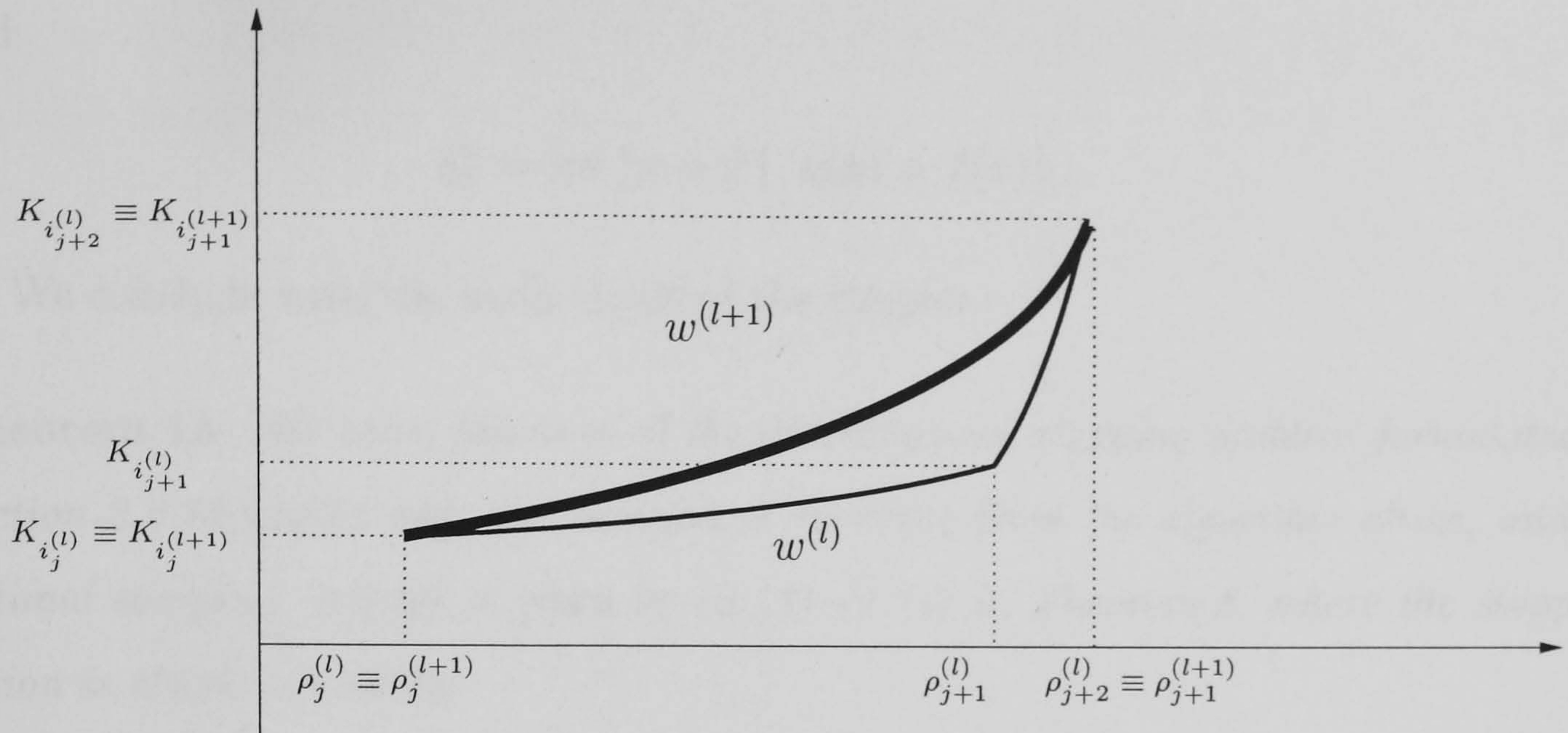


Figure 2.5: Illustration of two successive iterations of the algorithm that provides the solution to the HJB equation (2.7).

Plainly, this algorithm terminates after at most $N-1$ steps and each of the functions $w^{(l)}$ that the algorithm produces is a difference of convex functions. Also, any functions $w^{(l)}$ and $w^{(l+1)}$ produced by two consecutive iterations of the algorithm satisfy $w^{(l)} \leq w^{(l+1)}$, thanks to Lemma 9 (see also Figure 2.5). Also, we can easily check that the resulting function w satisfies the assumptions of Theorem 8, and, therefore, it identifies with our problem's value function.

Now, we define $N^\circ = \dim i^{(l)}$, and we denote by $(p_j^\circ)_{j=1, \dots, N^\circ}$ the strictly increasing finite sequence of points such that

$$p_0^\circ \equiv p_0, \quad p_{N^\circ}^\circ \equiv p_N \quad \text{and} \quad p_j^\circ \in \mathcal{C}^c \cap \mathcal{A}, \quad \text{for } j = 1, \dots, N^\circ,$$

where $\mathcal{C}^c = \{x > 0 \mid v(x) = f(x)\}$ (recall (2.12)) and \mathcal{A} is the set of points at which the discontinuities of f occur. Moreover, we define recursively

$$q_j^\circ := \inf \{x \geq p_j^\circ \mid v(x) > f(x)\}, \quad \text{for } j = N^\circ - 1, \dots, 1,$$

and

$$q_0^\circ := \inf \{x > 0 \mid v(x) > f(x)\}.$$

We conclude with the main result of the chapter.

Theorem 13 *The value function of the discretionary stopping problem formulated in Section 2.2 identifies with the function w resulting from the algorithm above, and an optimal stopping strategy is given by (2.13)–(2.14) in Theorem 8, where the stopping region is characterized by*

$$C^c =]0, q_0^\circ] \cup [p_1^\circ, q_1^\circ] \cup \dots \cup [p_{N^\circ-1}^\circ, q_{N^\circ-1}^\circ] \cup [p_{N^\circ}^\circ, \infty[,$$

with the convention that, $]0, 0] = \emptyset$.

Appendix

Proof of Lemma 10 By construction, we will show that \tilde{w} satisfies the HJB equation (2.7) for $x \in]y, z[$ if we prove that

$$\tilde{w}(x) \geq K, \quad \text{for all } x \in]y, z[. \quad (2.43)$$

To this end, we first note that the facts that $y < z$ and $K < L$, (2.30) and the definition of B in (2.34) imply that $B > 0$. In view of this observation and (2.30), we can see that

$$\tilde{w}'(x) \equiv A\varphi'(x) + B\psi'(x) \geq 0, \quad \text{for all } x \in]y, z[, \quad (2.44)$$

if and only if

$$-\frac{\psi'(x)}{\varphi'(x)} \geq \frac{A}{B}, \quad \text{for all } x \in]y, z[. \quad (2.45)$$

Now, using the fact that φ, ψ satisfy the ODE (2.26) and the expression (2.31) for their Wronskian, we can see that

$$\begin{aligned} \frac{d}{dx} \left(-\frac{\psi'(x)}{\varphi'(x)} \right) &= -\frac{\psi''(x)\varphi'(x) - \psi'(x)\varphi''(x)}{[\varphi'(x)]^2} \\ &= \frac{2r(x)\mathcal{W}(x)}{[\sigma(x)\varphi'(x)]^2} \\ &> 0, \quad \text{for all } x \in]y, z[. \end{aligned} \quad (2.46)$$

This inequality shows that (2.44)–(2.45) are both true if and only if

$$-\frac{\psi'(y)}{\varphi'(y)} \geq \frac{A}{B}. \quad (2.47)$$

Moreover, if (2.47) is not true, then $\tilde{w}'(x) < 0$ for all x sufficiently close to y , which, combined with the fact that $\tilde{w}(y) = K$, implies that (2.43) fails to be true. We conclude that (2.43) is true if and only if (2.47) holds, which, in view of the definitions of A, B in (2.33), (2.34), respectively, is equivalent to (2.35), and the proof is complete. \square

Proof of Lemma 11 In view of (2.30) and the fact that $K < L$, we can see that

$$F(z) = -\psi(z)[L - K] + \varphi(z)[L - K] \frac{\psi'(z)}{\varphi'(z)} < 0.$$

Also, with reference to (2.46), we calculate

$$F'(x) = [L\varphi(x) - K\varphi(z)] \frac{d}{dx} \left(\frac{\psi'(x)}{\varphi'(x)} \right) < 0, \quad \text{for } x \in]y, z[.$$

It follows that the equation $F(q) = 0$ has a unique solution $q \in]y, z[$ if and only if $F(y) > 0$, which is equivalent to (2.41).

With regard to its construction, we can see that the function \tilde{w} satisfies the HJB equation (2.7) for $x \in]y, z[$ if and only if

$$\tilde{w}(x) \geq K, \quad \text{for all } x \in [q, z[. \quad (2.48)$$

Now, following the same reasoning as in the proof of Lemma 10 above, we obtain

$$\tilde{w}'(x) \geq 0, \text{ for all } x \in]q, z[\Leftrightarrow -\frac{\psi'(q)}{\varphi'(q)} \geq \frac{A}{B}.$$

However, combining this observation with the fact that \tilde{w} is C^1 at q , which implies that

$$\tilde{w}(q) = K \quad \text{and} \quad \tilde{w}'(q) \equiv A\varphi'(q) + B\psi'(q) = 0,$$

we can see that (2.48) is true, and the proof is complete. \square

Proof of Lemma 12 With reference to the proof of Lemma 11, we can see that equation (2.39) has a unique solution $q \in]0, z[$ if and only if

$$\lim_{x \downarrow 0} F(x) \equiv \lim_{x \downarrow 0} \left[K\psi(z) + L\frac{\mathcal{W}(x)}{\varphi'(x)} - K\varphi(z)\frac{\psi'(x)}{\varphi'(x)} \right] > 0, \quad (2.49)$$

where \mathcal{W} is the Wronskian of φ and ψ defined by (2.31). To establish conditions under which this inequality is true, we calculate

$$\frac{d}{dx} \left(\frac{\mathcal{W}(x)}{\varphi'(x)} \right) = -\frac{2r(x)\mathcal{W}(x)\varphi(x)}{[\sigma(x)\varphi'(x)]^2} < 0,$$

which, combined with the inequality $\mathcal{W}(x)/\varphi'(x) < 0$, which is true for all $x > 0$, implies that $\lim_{x \downarrow 0} \mathcal{W}(x)/\varphi'(x)$ exists in $] -\infty, 0]$. However, this observation, the fact that $\lim_{x \downarrow 0} \psi(x)$ exists in $[0, \infty[$ because ψ is strictly positive and increasing, and the expression

$$\frac{\varphi(x)\psi'(x)}{\varphi'(x)} = \frac{\mathcal{W}(x)}{\varphi'(x)} + \psi(x), \quad \text{for } x > 0, \quad (2.50)$$

which follows immediately from the definition (2.31) of \mathcal{W} , imply that

$$\lim_{x \downarrow 0} \frac{\varphi(x)\psi'(x)}{\varphi'(x)} \in] -\infty, 0].$$

Now, we use a contradiction argument to show that this limit is actually equal to 0. To this end, we suppose that

$$\lim_{x \downarrow 0} \frac{\varphi(x)\psi'(x)}{\varphi'(x)} = -2\varepsilon, \quad \text{for some } \varepsilon > 0. \quad (2.51)$$

This assumption implies that there exists $x_1 > 0$ such that

$$-\frac{\varphi'(s)}{\varphi(s)} \leq \frac{1}{\varepsilon}\psi'(s), \quad \text{for all } s \in]0, x_1].$$

In view of this inequality, we can see that

$$\begin{aligned} \ln \varphi(x) &= \ln \varphi(y) + \int_x^y \left(-\frac{\varphi'(s)}{\varphi(s)} \right) ds \\ &\leq \ln \varphi(y) + \frac{1}{\varepsilon} [\psi(y) - \psi(x)], \quad \text{for all } 0 < x < y \leq x_1, \end{aligned}$$

which implies

$$\varphi(x) \leq \varphi(y) \exp \left(\frac{1}{\varepsilon} [\psi(y) - \psi(x)] \right), \quad \text{for all } 0 < x < y \leq x_1. \quad (2.52)$$

For fixed y , the right hand side of this inequality remains bounded as $x \downarrow 0$ because ψ is positive and increasing, which implies that (2.52) cannot be true because $\lim_{x \downarrow 0} \varphi(x) = \infty$. It follows that (2.51) is false, and, therefore,

$$\lim_{x \downarrow 0} \frac{\varphi(x)\psi'(x)}{\varphi'(x)} = 0 \quad \Rightarrow \quad \lim_{x \downarrow 0} \frac{\psi'(x)}{\varphi'(x)} = 0.$$

However, these limits and (2.50) imply that (2.49) is equivalent to the inequality $K\psi(z) - L\psi(0) > 0$, which establishes the claim regarding the solvability of (2.39).

Now, part (a) of the lemma is obvious, while part (b) follows by a straightforward adaptation of the arguments used to establish the corresponding claim in Lemma 11.

□

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